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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

April 25, 1997

CHART OF THE WEEK

State Electricity Reform Effort and Average Electricity Rates

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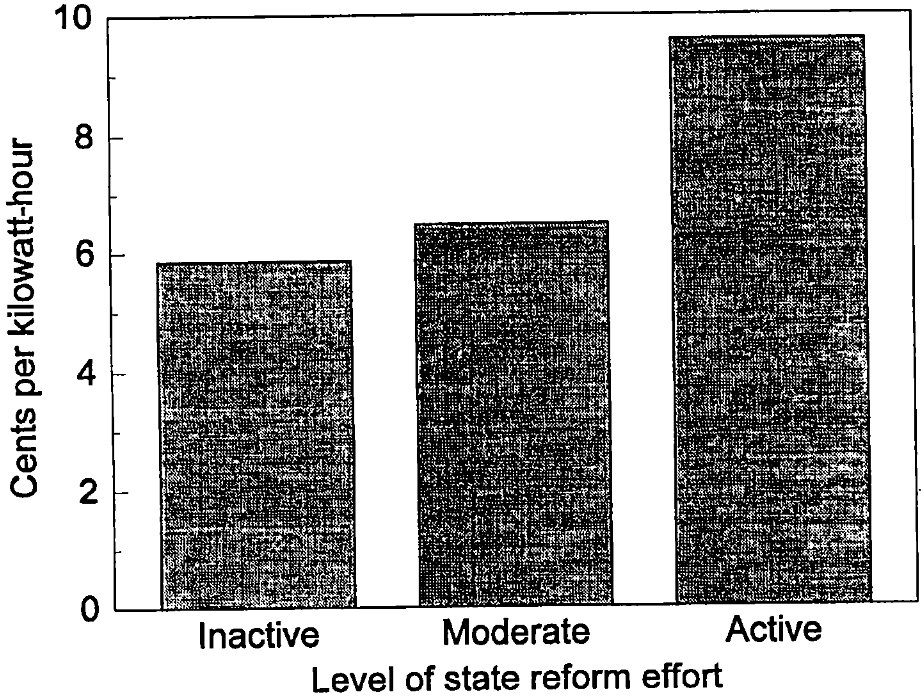

The intensity of state efforts to reform regulation of retail electricity is correlated with average electricity rates. States that already enjoy relatively low rates have little incentive for action. States with relatively high rates have reason to undertake active efforts to reform retail electricity regulation. Rates in states with active reform efforts underway are about one-third higher, on average, than rates in states that are inactive. A special analysis in this *Weekly Economic Briefing* examines the diversity of retail electricity prices across states.

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SPECIAL ANALYSES

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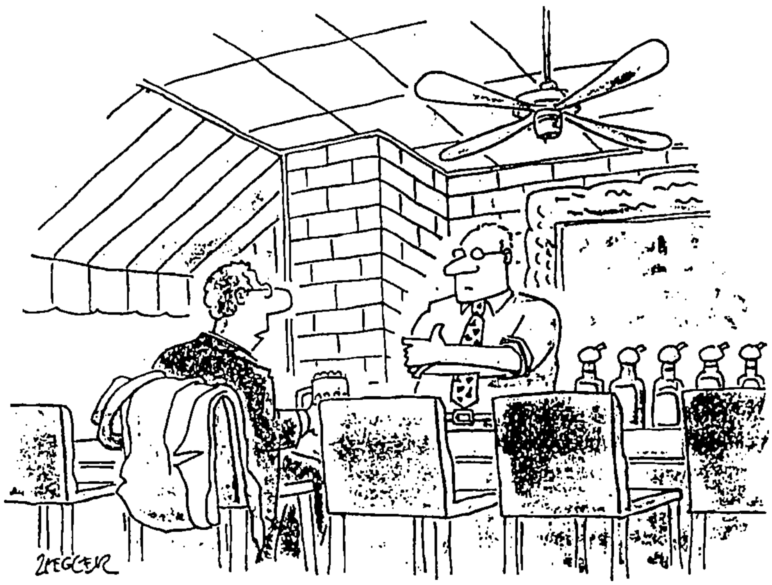
DEPARTMENTS



"Right now we're at a budget impasse. I maintain that you provide an essential service, and my wife feels that you do not."

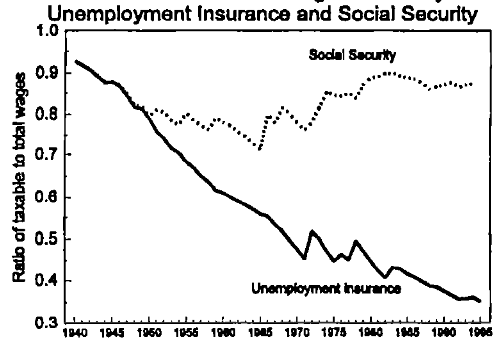
SPECIAL ANALYSIS

Unemployment Insurance Taxes and Low-Skilled Workers

Unemployment insurance (UI) will serve an important safety net role as large numbers of former welfare recipients make the transition from welfare to work (see *Weekly Economic Briefing*, April 18, 1997). Unfortunately, the current structure of UI financing disadvantages low-skilled workers.

The UI taxable wage base. Employers are assessed a UI tax on each worker's earnings up to a specified maximum. The Federal Government sets the minimum cap, currently $7,000, but states have the option of setting a higher amount. Although many states have set their maximum taxable earnings amount for UI somewhat above the Federal minimum, many have not—including large states such as New York, California, and Florida.

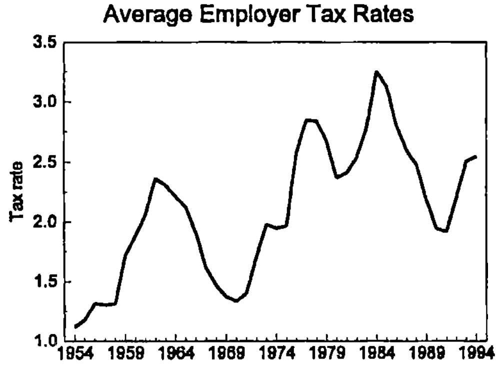
Share of Covered Earnings Taxable by Unemployment Insurance and Social Security



In 1940, the maximum taxable earnings for both UI and Social Security was $3,000 (about $35,000 in 1996 dollars) and covered virtually all earnings at that time. Since then, a series of ad hoc adjustments, and indexation implemented in 1972 legislation, has kept the Social Security maximum roughly constant in real dollars. But most states do not index the UI taxable wage base or make frequent adjustments. As a result, the maximum taxable earnings for UI has fallen dramatically relative to that for Social Security (see upper chart).

Implications. As a share of earnings, the UI tax for a full-time, year-round minimum wage worker is currently five times as great as it is for someone making $40,000 in a year. To the extent that employers absorb the tax, they are discouraged from hiring relatively less-skilled workers. To the extent that the tax is passed on to workers, less-skilled workers see a larger proportional reduction in their wage.

Average Employer Tax Rates



This regressivity of the UI tax is likely to become more severe over time if the taxable wage base remains fixed in nominal dollars and the financing needs of the system are met by raising the tax rate. Unlike the taxable wage base, UI benefits generally are indexed for inflation, or at least adjusted frequently. And the tax rate does display a general upward trend (see lower chart).

SPECIAL ANALYSIS

State Reform of Electricity Regulation: The Role of Prices

One measure of how regulation has inhibited retail competition in electricity is the wide range of prices that can be observed across states. Unsurprisingly, efforts to encourage retail competition tend to be stronger in states with higher rates.

An astounding divergence. In competitive markets, large price disparities normally encourage suppliers in areas where prices are low to divert their output to areas where prices are high. This would drive up the price in low-price areas and drive down the price in high-price areas until those prices are approximately identical (taking into account transportation costs). In electricity, however, average retail prices range from about 4 cents per kilowatt-hour (kWh) in Washington, Idaho, and Kentucky to over 11 cents per kWh in Hawaii, New York, and New Hampshire. Nor is this disparity unique to a few states. Average retail rates are below 6 cents per kWh in 18 States, and over 9 cents per kWh in 11 States.

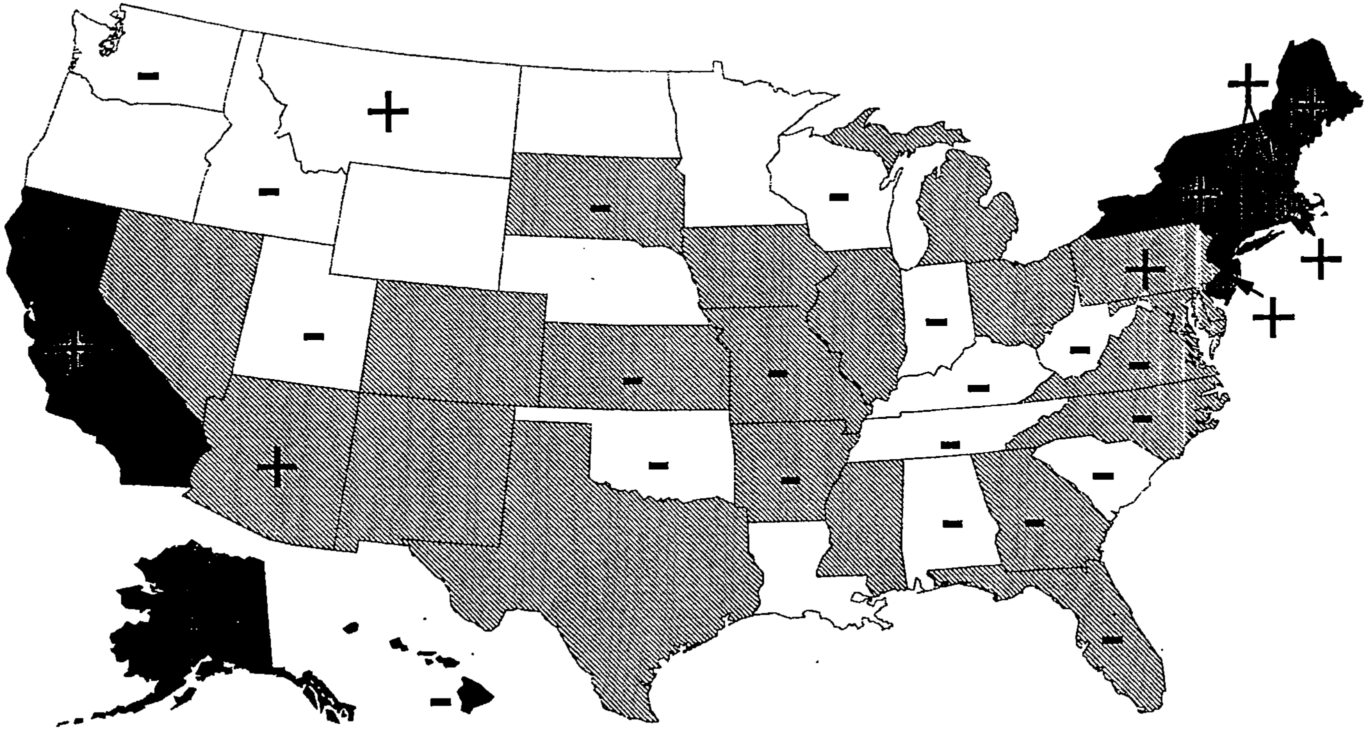
Why are electricity rates so different? Geographic factors play a role. States with utilities that have access to relatively inexpensive hydroelectric power or those located close to coal mines or other fuel sources have relatively low rates. But decisions by utilities and their regulators matter as well. For example, construction difficulties and tighter safety standards following the 1979 Three Mile Island mishap made nuclear power extremely expensive, raising costs for utilities that had gone that route. Differences across states in implementing the 1978 Public Utility Regulatory Policies Act (PURPA) have also contributed to rate disparities. Many states imposed long-term obligations on utilities to buy what has turned out to be relatively high-cost power produced either by renewable sources or by "cogenerators" that generate electricity in the course of their industrial operations.

Big buyers get cheaper power. The average electricity price for industrial customers (4.7 cents per kWh) is almost one-third lower than the average retail price nationwide (6.9 cents per kWh). Industrial customers benefit both from potential scale economies in serving large customers and from increased competition, in that they can threaten to relocate to other States or produce their own electricity if local utilities do not offer favorable rates. Retail competition could bring these lower industrial prices to residential and commercial users as well.

High-cost states respond as expected. States with high electricity rates have an incentive to reform a regulatory system that insulates local utilities from low-cost entrants and power producers across the country. As the map on the following page illustrates, the states that have been most active in changing laws or regulations to open retail markets are, by and large, the same ones with prices over 9 cents per kWh. It is an open question whether the momentum toward retail competition in these states will eventually carry over to areas of the country where electricity prices are only about half as high.

Electricity Prices and Retail Competition

(prices in cents per kilowatt-hour)



■ More than 9 cents ▨ 6 - 9 cents □ Less than 6 cents

\+ Most active states - Least active states

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SPECIAL ANALYSIS

Is the Dairy Program Feeling Its Age?

Many key provisions of today's convoluted dairy policy are a legacy of conditions prevailing in the dairy industry earlier in the century (see box on next page). The program aims to increase and stabilize farmers' incomes. But in so doing, it transfers income from consumers to producers, burdens taxpayers, and harms the environment.

Current policy. Important features of the current program include the following:

- The Federal dairy program maintains a distinction between milk for fresh-market consumption and that which is used to make manufactured products such as cheese, butter and powdered milk.
- The program sets a floor under the price of processed milk and purchases surplus output, mainly cheese and butter, in order to maintain the price.
- A set of 32 regional marketing orders specify the increment in the price of fresh milk over that of processed milk. The increment is based on the distance between the geographical center of the region and Eau Claire, Wisconsin.
- Farmers receive a price that is a "blend" of the price of fresh milk and the price of processed milk, irrespective of the actual use of their milk.
- Individual states are free to opt out of the Federal program. California, which produces about 15 percent of all milk in the country, maintains its own dairy program. (The Northeast Interstate Dairy Compact, which raises the price of fresh milk above what it would be under the Federal program, is another prominent exception to the basic national system.)

Economic effects. Three important effects can be identified:

- Higher prices for fresh milk. A recent study found that the Federal dairy program has increased the price of fresh milk by 6.5 percent and transferred an average of over $1 billion from consumers to producers each year since 1949; this amounts to over $500 per month for an average dairy farmer. In some years the cost to consumers has been much higher. In 1980, for example, the Federal dairy program cost consumers nearly $5 billion. Because milk is an important part of children's diets for which relatively few substitutes exist, low-income families are most seriously harmed by an increase in fresh milk prices.
- Costs to taxpayers. The blend price paid to farmers is generally above the incremental value of milk in processed markets, resulting in overproduction. Taxpayers must pay to remove surplus dairy products from the market. The cost of these removals has varied widely from year to year as production has fluctuated in response to changes in demand and farm input prices. In the 1980s, the USDA actually paid farmers not to produce milk to keep its stocks from growing out of control. In 1983 direct taxpayer costs of milk removals peaked

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at $2.6 billion. Recently, taxpayer costs have fallen sharply as domestic demand for cheese and butter has increased. Chronic surpluses may well re-emerge, however, as farmers increase production.

- Environmental damage. Water pollution from dairy farm runoff is a significant concern in many parts of the country. This public health problem is especially serious in rural areas where a large majority of residents rely on groundwater for their drinking water supplies. Policies that increase dairy production also increase this environmental damage.

Implications. To a large extent, the original motivations for Federal dairy supports have disappeared (although many economists would argue that they were never compelling). Advances in storage technologies and lower transportation costs have broken down regional barriers to milk marketing. Many industries in the United States plan production and marketing on a daily basis, and the rapid adoption of just-in-time inventory management is a good example of this trend. Furthermore, it is no longer more expensive to produce fresh-market milk, and as a result nearly all U.S. milk meets Grade-A standards.

The 1996 Farm Act overhauled much of American agricultural policy, replacing numerous government controls with a more market-based system. Federal dairy policy was largely untouched by that legislation, but will have to be addressed before the current policy expires in 1999.

Origins of the Dairy Program

Federal dairy programs date back to the 1930s, when farmers demanded that the government ensure "orderly" dairy marketing. At that time, milk was difficult to store and expensive to transport. Farmers were thus susceptible to price fluctuations in the local market. The price support feature of the Federal program was intended to insulate dairy farmers from these price changes. The differential price paid for fresh milk was motivated by the higher cost of producing more sanitary milk for the fresh market. Varying the fresh market price according to the distance from Wisconsin was intended to reflect transportation costs from the main dairy-producing region.

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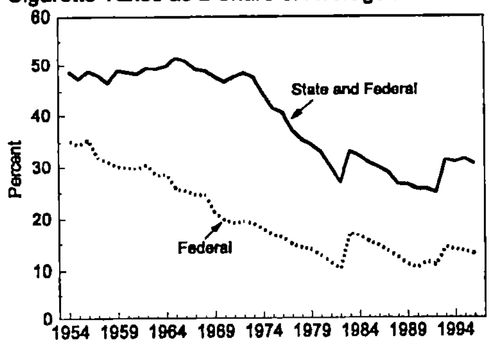
ARTICLE

Cigarette Prices and Smoking Behavior

The Federal Government has raised the excise tax on cigarettes only three times in the last 45 years. Recently, however, a number of states have hiked their cigarette taxes, and the Kennedy-Hatch health care proposal would increase the Federal tax by 43 cents per pack. Moreover, some observers have speculated that the tobacco companies might raise prices to pay for any settlement coming out of current negotiations. How would higher prices affect smoking behavior?

Cigarette taxes. Federal and state taxes together used to represent about half the retail price of cigarettes. Now, as their value has been eroded by inflation, they represent less than a third (see chart). A 43-cent-per-pack increase in Federal taxes would, if passed on fully to consumers, raise the price of cigarettes by about 23 percent, from $1.85 to $2.28 per pack. The combined Federal and state taxes would still be a smaller percentage of the price of cigarettes than they were in 1974.

Cigarette Taxes as a Share of Average Retail Price



Do prices affect smoking behavior? A substantial body of research indicates that higher cigarette prices discourage smoking. A reasonable estimate is that a 23 percent increase in the price of cigarettes would cut smoking by about 9 percent in the short run and by almost twice as much over a longer period of time. It takes time for the full effect to be felt because cigarettes are addictive and many people do not curtail or stop smoking immediately. In addition, a tax increase gradually reduces the prevalence of smoking by discouraging persons from taking up the habit.

Health benefits. Higher cigarette taxes are likely to improve public health. One recent study implies that a 23 percent increase in the price of cigarettes would save around 14,000 lives per year, due to reduced cardiovascular disease and respiratory cancers. Another study finds that increases in cigarette taxes reduce the incidence of low birth weight, an important indicator of infant health.

Are cigarette taxes regressive? The poor are more likely to smoke than the affluent, which implies that cigarette taxes are regressive. This does not mean, however, that increases in cigarette taxes necessarily impose a disproportionate burden on the less well-off. It appears that less-educated and lower-income smokers are more responsive to price increases than those with higher education and income. Moreover, the combination of higher initial rates of smoking and possibly greater responsiveness to price means that the health benefits of higher cigarette taxes will also tend to accrue disproportionately to the poor. Finally, taxation appears to be a

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particularly effective way of deterring young people from smoking (in part because of their low incomes) and is therefore likely to have particularly long-lasting health benefits.

Could Cigarette Prices Become Too High?

The short answer is probably not, given the size of likely increases and the health benefits from reduced smoking. But two issues deserve mention.

Do smokers pay their way? One study finds that cigarette taxes are currently at about the right level to cover the economic costs smokers impose on non-smokers. In particular, although smokers require additional medical care, most of the extra cost is offset by lower expenses for retirement pensions and nursing home care resulting from smokers' shorter life expectancies. However, the study did not fully account for some costs imposed by smoking (such as the costs of second-hand smoke or of smoking by pregnant women). Of course, even if smokers do "pay their way," other economic and social factors play a role in setting tax rates. For example, nicotine addiction typically begins at young ages when people may be ill-equipped to understand the long-term implications of their decision to take up smoking. And society may value the health and longevity benefits achieved through reduced smoking.

Smuggling. The Canadian government substantially increased cigarette taxes during the 1980s and early 1990s. (In Canadian dollars, the Federal tax rose from 42 cents per pack in 1984 to $1.93 in 1992.) This led to higher prices and reduced smoking. However, partly out of concern that the high prices were encouraging smuggling, the taxes were sharply reduced in 1994. Three factors promoted smuggling prior to the "roll-back:"

- the large differential between cigarette prices in the United States and Canada
- the relative ease of transporting cigarettes between the two countries
- what some claim was an active effort by Canadian tobacco companies to encourage smuggling.

Although the decrease in tobacco taxes may have reduced smuggling, the evidence suggests that the price reduction is encouraging more Canadians to smoke.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Private School Vouchers and Student Achievement. Results from Milwaukee's experiment with private-school vouchers have been controversial, partly because of an inadequate experimental design (see *Weekly Economic Briefing*, September 27, 1996). Those enrolled in private schools differed from their comparison group in ways that are likely to be related to educational outcomes, making a direct comparison inappropriate. A recent study reexamining the data from this experiment attempted to correct for the design flaws. It found some evidence of a positive effect from vouchers. Estimates indicate that math scores of school-choice enrollees rose more than those of similar students who remained in the Milwaukee public schools (1.5 to 2 percent higher for each year of private school enrollment)—although reading scores were no higher. Still, these results should be interpreted cautiously. Although these statistical corrections may have reduced the potential biases introduced by an imperfect experimental design, it is unlikely that the flaws have been eliminated.

IRS Releases Report on EITC Error Rates. An Internal Revenue Service study analyzing non-compliance rates associated with the earned income tax credit (EITC) estimates that 25.8 percent of EITC claims for the 1994 tax year (returns filed between January and April 1995) exceeded the amount to which taxpayers were entitled. Improved IRS enforcement practices and tighter procedural rules enacted in 1996 would have reduced the error rate by an estimated 5 percentage points, had they been in place for the 1994 tax year. The results from this study should be compared to error rates in excess of 35 percent the last time the IRS conducted a study of a comparable group of taxpayers (for the 1988 tax year). The EITC error rates reported in this year's study are still viewed as too high (even though non-compliance in other ~~areas, such as~~ the reporting ~~of business~~ income, are substantially higher). In response to the study's findings, the Treasury Department announced a set of legislative and administrative proposals designed to ensure that the EITC goes only to taxpayers who are eligible.

Immigrants Have Little Effect on Native Migration. One of the most convincing pieces of evidence suggesting that immigrants do not displace natives in the labor market was Miami's experience with the 1980 Mariel boatlift. One influential study found no discernible effect from the large inflow of these Cuban refugees on the employment and wages of native-born residents of Miami. The main criticism of this study has been that immigrant inflows into particular areas may lead to an exodus of natives that would dampen any displacement effects. A new study finds that outflows of older immigrants and natives of the same skill level in response to heightened immigration were much smaller than the inflow of new immigrants. Cities that received large inflows of recent immigrants had sharp increases in the relative share of their labor force that is low-skilled. The study also concludes that immigration does have small effects on the level of employment and wages earned by natives and older immigrants.

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INTERNATIONAL ROUNDUP

United States May Pass Japan as World's Largest Aid Donor. Due to a combination of unusual factors, the OECD may determine that the United States was the world's largest contributor of official development assistance (ODA) in 1996. The value of U.S. donations for 1996 will be bolstered by the OECD's decision to include 2 years of U.S. annual aid to Israel in the 1996 total, because the disbursement originally designated for 1995 was delivered too late to count for that year. On the Japanese side, a combination of a weaker yen and fiscal tightening in Japan have contributed to a 35 percent decline in Japanese aid measured in dollars. Preliminary estimates indicate that the value in 1996 will be close to $9.6 billion. In addition, delays in negotiations to replenish the International Development Association (part of the World Bank) and the Asian Development Bank have led to a temporary drop of 70 percent in Japan's contributions to multilateral organizations. Japan first surpassed the United States in levels of ODA in 1989. In terms of contributions as a share of GDP, the United States still ranks below Japan, and, since 1990, it has contributed a smaller share of its GDP to ODA (about 0.16 percent, on average) than nearly any of the 21 major contributing nations.

Western Hemisphere Regional Trading Arrangements Progress—Without U.S. A series of meetings this week between the Andean Community (Venezuela, Colombia, Ecuador, Peru, and Bolivia) and the Mercosur countries (Argentina, Brazil, Paraguay and Uruguay) will reportedly conclude with a declaration that could pave the way for a gradual merging of the two largest trading blocs in South America. Ties between the two are already fairly strong. Bolivia, for example, was a founding member of the Andean Pact but already enjoys associate membership in Mercosur. Peru, which this week expressed frustration with the structure of the Andean Community, has also approached Mercosur concerning associate membership. Meanwhile, closer cooperation between the two Americas is being pressed by Canada as it begins negotiations with Mercosur countries. The Canadians are meeting with the Brazilians this week and hope to negotiate a trade and investment agreement between Canada and Mercosur. Canada has already concluded a trade agreement with Chile, an associate member of Mercosur.

The Brussels EMU Forecasts—A Leap of Faith? According to the European Commission's latest forecast, all EU countries except for Greece and Italy will meet the EMU public deficit target of 3 percent of GDP. The IMF forecasts, however, were strikingly less optimistic. According to the IMF, only 9 of the 15 EU countries will meet the deficit criterion for EMU, and, significantly, France and Germany are not among this elite group of nine. Unsurprisingly, a number of analysts regard the European Commission's forecasts as tainted by politics. Others believe that the European Commission's forecasts have better accounted for the extraordinary measures that some countries (like Germany) are willing to undertake in order to meet the 3-percent target. In any case, slow growth and high unemployment in France, Germany, and in other European countries will require that painful fiscal measures be adopted if the Commission's predictions are to be realized.

RELEASES THIS WEEK

U.S. International Trade in Goods and Services
****For release at 10 a.m., Friday, April 25, 1997****

As reported last week, the goods and services trade deficit declined to $10.4 billion in February from $12.3 billion (revised) in January.

MAJOR RELEASES NEXT WEEK

Employment Cost Index (Tuesday)
Advance Durable Shipments and Orders (Tuesday)
Consumer Confidence—Conference Board (Tuesday)
Gross Domestic Product (Wednesday)
NAPM Report on Business (Thursday)
Leading Indicators (Friday)
Employment Situation (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1996	1996:2	1996:3	1996:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.1	4.7	2.1	3.8
GDP chain-type price index	5.3	2.1	2.2	2.0	1.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.9	0.6	0.0	1.1
Real compensation per hour:					
Using CPI	0.6	0.4	0.5	0.7	0.2
Using NFB deflator	1.3	2.2	2.0	2.0	2.7
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.4	10.3	10.6	10.6
Residential investment	4.5	4.1	4.2	4.1	4.1
Exports	8.2	11.3	11.3	11.1	11.5
Imports	9.2	12.6	12.6	12.7	12.6
Personal saving	5.1	3.6	3.2	3.9	3.8
Federal surplus	–2.7	–1.7	–1.7	–1.6	–1.4

	1970–1993	1996	Jan. 1996	Feb. 1997	Mar. 1997
Unemployment Rate	6.7**	5.4**	5.4	5.3	5.2
Payroll employment (thousands)					
increase per month			259	293	175
increase since Jan. 1993					11926
Inflation (percent per period)					
CPI	5.8	3.3	0.1	0.3	0.1
PPI-Finished goods	5.0	2.8	–0.3	–0.4	–0.1

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

FINANCIAL STATISTICS

	1995	1996	Feb. 1997	Mar. 1997	April 24, 1997
Dow-Jones Industrial Average	4494	5743	6917	6901	6792
Interest Rates					
3-month T-bill	5.49	5.01	5.01	5.14	5.18
10-year T-bond	6.57	6.44	6.42	6.69	6.93
Mortgage rate, 30-year fixed	7.95	7.80	7.65	7.90	8.08
Prime rate	8.83	8.27	8.25	8.30	8.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level April 24, 1997**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.717	–0.5	12.8
Yen-Dollar	126.0	–0.1	18.0
Multilateral $ (Mar. 1973=100)	96.60	–0.3	9.9

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.1 (Q4)	5.2 (Mar)	2.8 (Mar)
Canada	2.3 (Q4)	9.7 (Feb)	2.2 (Feb)
Japan	3.1 (Q4)	3.4 (Feb)	0.7 (Feb)
France	2.1 (Q4)	12.8 (Dec)	1.6 (Feb)
Germany	2.2 (Q4)	7.6 (Dec)	1.7 (Feb)
Italy	0.1 (Q4)	12.3 (Jan)	2.4 (Feb)
United Kingdom	2.0 (Q4)	7.2 (Feb)	2.7 (Feb)