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Weekly Economic Briefing of POTUS - 5/26/2000

Ricchetti
make sure VP & his
campaign know — we
fought for HOPE, Lifetime, Child Credits, they
fought for cap gains
BC

5-30-00

'00 MAY 26

WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

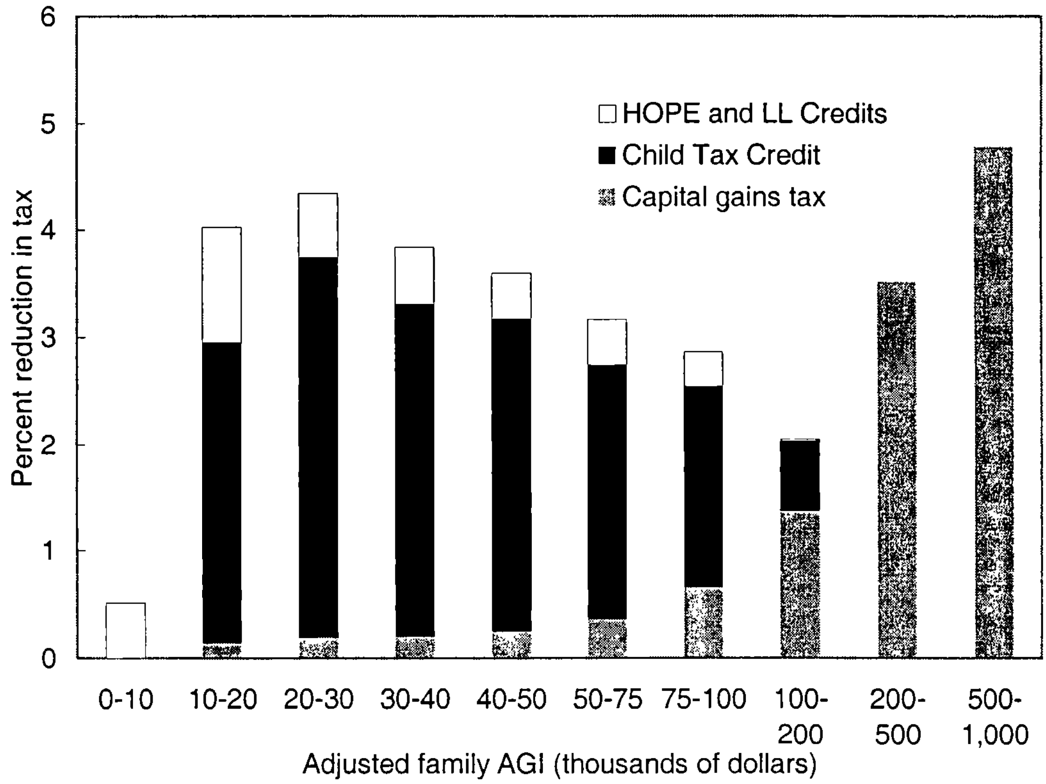
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

May 26, 2000

Copied
Ricchetti
Podesta
VP

CHART OF THE WEEK

Effects of TRA-97 Provisions on Tax Burdens in 1999



Three major tax reduction provisions of the Tax Relief Act of 1997 (TRA-97) lowered federal income taxes for all income groups. Based on a tax simulation model, the HOPE, Lifetime Learning, and Child Tax Credits significantly reduced taxes—measured by the sum of payroll and individual income taxes—for low to middle income families, while the capital gains tax reduction primarily benefited higher income families.

PHOTOCOPY
WJC HANDWRITING

THE PRESIDENT HAS SEEN
5-30-00

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SPECIAL ANALYSES

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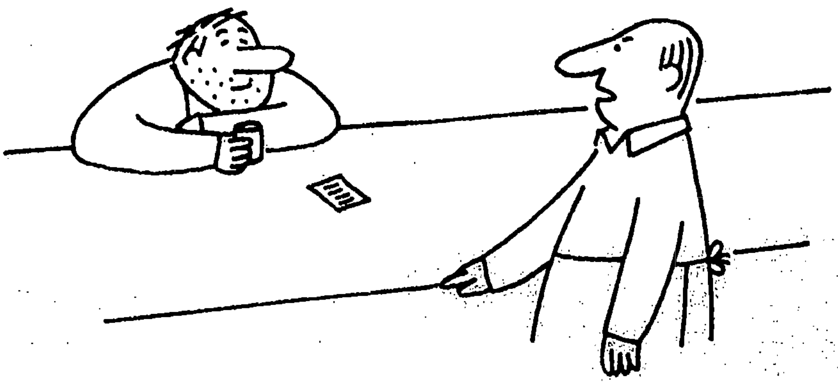
DEPARTMENTS



"I don't want stock options. I want you to pay your tab."

Copied
Baily
Podesta
pg 1 + pg 4.
Sperling
Pg 7.
Reed

420603

5-30-00

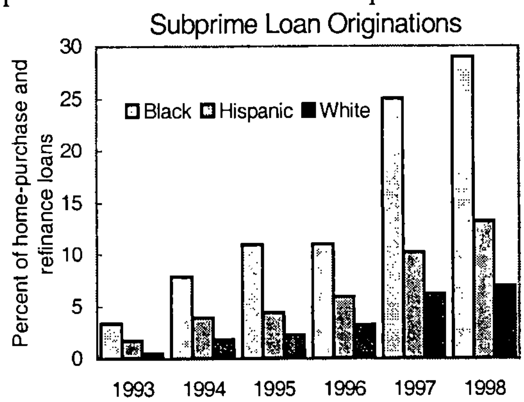
JP/Gene
can we do
anything about
this?
BC

SPECIAL ANALYSIS

Keeping Predatory Lending at Bay

Increased access to mortgages for people with less-than-perfect credit has contributed to the rise in the share of American households who own homes, which at 67 percent is the highest on record. Unfortunately, this expanding "subprime" market may also be providing fertile ground for the growth of predatory practices by some lenders that can rob borrowers of hard won equity in their homes—often their only significant asset.

The subprime market. The mortgage market is divided between prime loans for those borrowers with unblemished credit and subprime loans for those with poorer credit. About one-quarter of all subprime loans in 1998 were for home purchases and the other three-quarters were for home refinance. Subprime lenders—typically finance or mortgage companies not subject to routine regulatory compliance audits—face higher screening costs and greater default risk in making these loans and therefore charge fees and interest rates above those of the prime market. Racial and ethnic minorities are more likely than whites to be subprime borrowers. In 1998, subprime loans accounted for 29 percent of all home purchase and refinance loans issued to African Americans, 13 percent to Hispanics but only 7 percent to whites (see chart).



copied
Sperling

Growth in subprime lending. The number of subprime loan originations has increased over 15-fold since 1993. Subprime home-purchase loans have helped to make mortgage credit and homeownership more widely available. Between 1993 and 1998, the total number of home-purchase loans to African American borrowers increased 95 percent (as compared to 40 percent for whites), with nearly one third of that increase accounted for by subprime loans.

Predatory lending practices. Anecdotal evidence of abusive and predatory lending practices, particularly in low-income urban areas, have accompanied the growth of the subprime market. In addition to outright fraud, predatory practices include the steering of prime borrowers into subprime loans, excessive interest rates and fees, prepaid credit insurance, and the making of short-term or unaffordable loans. This last practice, often referred to as loan "flipping," ensures that the loan will have to be refinanced in a short time, providing the creditor with additional origination fees and prepayment penalties, which are then financed out of homeowners' equity. This is akin to a securities broker "churning" a customer's stock portfolio, with fees eating into the principal with each successive purchase and sale.

Market imperfections may facilitate predation. The combination of consumers with limited credit experience and the absence of standardized loan products creates an environment in which these abusive practices, despite being so damaging, are not driven out by market forces. For example, a recent survey found that only 49 percent of African American respondents with "good" credit records self-assess their own records as either "good" or "very good" (compared to 72 percent of white respondents), which may make them more likely to rely on subprime and predatory lenders than necessary. In addition, the lack of standardized loans has limited competition in subprime lending.

Possible remedies. Low-income and minority borrowers have increasingly benefited from a rapidly growing subprime market, but this has come at the cost of an apparent expansion in predatory lending practices. A HUD-Treasury Joint Task Force and the House Banking and Financial Services Committee are considering proposals to limit abuses. The prohibition of particularly abusive practices such as single premium credit life insurance and restrictions on the ability of the secondary market to securitize predatory loans could improve consumer welfare. Improved financial education, tightened disclosure rules and enforcement, and the encouragement of the increased entry of regulated financial institutions into the subprime market are other potential ways to combat abusive lending.

We should propose action on this

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5-30-00

SPECIAL ANALYSIS

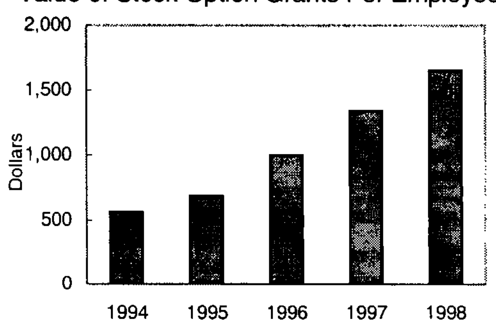
The Growing Importance of Employee Stock Options

Employee stock option plans have rapidly become an important form of compensation for employees and a powerful recruiting tool for companies, especially in technology industries. The rapid expansion of such compensation has created new challenges in measuring corporate profitability and has stimulated a debate regarding the appropriate tax treatment of stock options.

Stock option plans. A variety of stock option plans exist, but the most common type of option allows an employee to buy a predetermined number of shares at a fixed price, often the market price at the time the option is granted. If the market price subsequently rises above the fixed price, the option holder can exercise the option by purchasing the stock. The stock can be sold for an immediate profit or held in anticipation of future gains. Employers favor stock option plans because they provide workers with a stronger incentive to improve company performance and because they are treated more favorably than ordinary salary expenses under current accounting rules. For employees, stock options may represent a potentially lucrative opportunity to share directly in the fortunes of their employers. However, they may also increase the uncertainty and variability of workers' income.

Rapid growth. Stock option plans have spread quickly. A Fed study covering the 125 largest nonfinancial firms in the S&P 500 found that the value per employee of annual stock options grants nearly tripled between 1994 and 1998 (see chart). Another survey found that these plans are not reserved exclusively for executives. The informal survey found that 34 percent of businesses offered stock option plans to nonexecutives. But fewer than 10 percent had programs available to employees below the managerial and professional level. This extraordinary growth suggests that businesses have been shifting the compensation mix toward option-based pay and away from traditional salaries. According to a recent study, the growth in stock options may have increased the actual annual growth rate of economy-wide employment costs in the range of 0.25 to 0.75 percentage point between 1994 and 1998—a figure not counted in the official Employment Cost Index.

Value of Stock Option Grants Per Employee*



* For 125 largest nonfinancial firms in the S&P 500

Are stock options expenses? This rapid growth in stock options has created new challenges in measuring the profitability of companies. Although stock options represent a cost of doing business, current financial accounting rules do not require firms to report the cost of the most common type of option as an expense

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on their income statement. As a result, earnings reported on the income statement understate the true cost of their operations and hence overstate their profitability. This discrepancy is not trivial: at the 125 S&P 500 firms discussed above, the value of stock options granted could have represented as much as 8 percent of reported profits in 1998. The Financial Accounting Standards Board (FASB) has encouraged firms to report stock option costs as a compensation expense—a convention that would conform more closely to the economic definition of labor costs. However, the FASB has continued to allow companies to omit most stock option transactions from the income statement, provided they make pro forma disclosures of net income with the cost of these options treated as an expense.

How should stock options be taxed? The taxation of stock options differs across types of option plans, both in terms of the corporate income tax paid by the employer and the personal income tax paid by the employee. Congress is currently considering the creation of a "super stock option." This new option would combine the most favorable tax treatment of existing option plans for both employers and employees. Employers would be able to deduct stock option costs from taxable income when the options were granted or exercised. Workers, on the other hand, would only pay taxes at the capital gains rate (assuming certain requirements are met) and the tax would be deferred until the resulting shares are sold. This approach would create a further tax-based incentive to substitute option-based compensation for standard salary income, but there is no clear economic rationale for subsidizing this particular form of compensation.

Gene
Should we do this?
BC

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Sperling

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WJC HANDWRITING

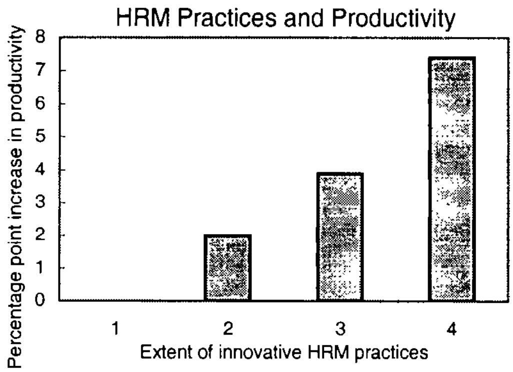
5-30-00

ARTICLE

Innovative Human Resource Management Practices

Firms have increasingly introduced innovative human resource management (HRM) practices ~~that are aimed at greater employee~~ involvement in decision making. It is estimated that about half of all establishments have adopted some form of employee involvement program, ~~and~~ that the vast majority of these programs were introduced since 1987. To what degree do these innovative HRM practices raise workers' productivity, and how do these practices change the demand for less-skilled workers?

HRM effects on productivity. One recent study examined productivity differences among 41 comparable steel finishing lines in the United States and Japan. In this study, the HRM practices are divided into four groups, with the lowest group (#1) having no innovative practices and the top group (#4) having a comprehensive set of innovative practices. Innovative practices include extensive communications with workers, off-site training, worker rotation across jobs, extensive participation by production workers on problem-solving teams, and pay that is a function of multiple attributes of performance. Based on monthly production data from steel production lines, productivity rises as the extent of innovative HRM practices increase from the lowest to highest HRM groups (see chart). The very high returns to adopting the comprehensive innovative HRM practices suggest that individual HRM practices are particularly successful when they are adopted in unison; for example, problem-solving teams are most likely to be productive when used with other innovative practices.



Where do innovative HRM practices have the greatest impact? Evidence from another study of steel mills suggests that innovative HRM practices are most valuable in plants that produce higher-quality products or that use more sophisticated production processes—and therefore require a greater degree of problem-solving on the part of operators. These are also likely to be the plants that pay the highest wages. Plants that produce commodity products and emphasize low-cost production are less likely to gain from the investment in innovative HRM practices.

Plants that invest in innovative HRM practices are also more likely to have extensive IT ~~investments,~~ and evidence suggests that innovative HRM practices enhance the return to IT. In manufacturing, IT puts more minute-by-minute production information in the hands of front-line operators who are running the production lines from the computerized pulpits. Innovative HRM practices that

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enable operators to use this new information to make decisions can produce higher productivity outcomes.

Problem-solving skills for high-school educated workers. As innovative HRM and IT are combined in the workplace, there is a much greater need for the development of analytical problem-solving skills among the high-school educated workers who are empowered with more decision-making on the production line. These workers need to be fluent in basic skills—reading, math, and basic computer use—but their key to higher performance and higher wages lies in their ability to solve problems on the job.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Smoking and the Relationship Between Socioeconomic Status and Health. While it is well-known that women of lower socioeconomic status (SES) are more likely to have infants with poor health, a recent study finds that a key reason for this is maternal health habits, particularly smoking. Babies born to women over age 20 without a high school diploma are nearly twice as likely to die before their first birthday as babies born to college graduates. While this strong association between health and SES has been well-documented, the fundamental causes of the relationship are poorly understood. The study finds that in 1988, maternal health habits during pregnancy explain about half of the correlation between SES and low birth weight (low birth weight babies are 20 times as likely to die as other infants). In particular, smoking significantly increases the likelihood of low birth weight. The author stresses that because many health habits begin early in life, policies should target these harmful health behaviors among youth.

Bruce
any way
to get more
attention

Supply and Demand Jointly Determine Marijuana Use. The price of marijuana has a substantial impact on its use by youth, as do teenagers' perceptions of the harms associated with regular marijuana use, according to a recent study. A 10 percent increase in price is associated with approximately a 3 percent decline in use. Similarly, a 10 percentage point increase in the number of teens who believe regular marijuana use is harmful lowers annual participation by about 5 percentage points. The percent of high school seniors who report smoking marijuana in the previous year fell from about 45 percent in 1982 to a low of 22 percent in 1992. During this time, changes in price explain 55 percent of the decline while changes in perception of harm explain 40 percent. In 1992, the trend reversed and marijuana use started to increase, reaching 38 percent in 1998. Falling perceptions of harm are the dominant explanation of the increase, accounting for 80 percent, while changes in price had little effect.

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Reed

Why Aren't There More Women in Business School? Female enrollment at top business schools has plateaued at 30 percent, compared with peaks of 44 percent in law and medical schools. While an equally high percentage of male and female graduates from 12 of the nation's top business schools report being satisfied with the business school experience and their post-MBA careers, female MBA graduates are less satisfied than their male counterparts with business school culture, according to a recent study. In particular, women are less likely to feel they could relate to the people in case studies and somewhat more likely to feel the environment was overly aggressive. While the study does not provide a comparative analysis of different professions, several results suggest why this difference may exist. For example, focus groups of women who chose to pursue professional degrees other than an MBA considered the business world intolerant of diversity, male dominated, and overly focused on financial gain rather than social improvement.

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INTERNATIONAL ROUNDUP

More Sub-Saharan African Women Want to Limit Births. The percent of women who want no more children has risen steadily since the 1970s in sub-Saharan Africa, according to a new study, reaching levels ranging from 20 to 40 percent in many countries by the late 1990s. One dramatic example is Kenya, where this proportion rose from 15 percent in 1977 to 46 percent in 1998. These levels, however, remain far below those seen in Asia and North Africa (40-60 percent) and in Latin America (where the proportion exceeds 60 percent in five of 11 countries studied). But not all of the women in Sub-Saharan Africa who want to limit births are using contraception. The share of fecund married women who would like to limit births but do not use contraception increased fairly uniformly in the region. In contrast, in Asia, North Africa, and Latin America the number of those who wish to stop having children but do not practice contraception has fallen sharply over the last two decades.

Swiss Voters Agree to Bilateral Agreements with EU. In a referendum last Sunday, Swiss voters overwhelmingly approved a set of seven bilateral agreements between Switzerland and the European Union which would allow gradual opening of transit, labor, and goods and services markets on a reciprocal basis. Although the EU is Switzerland's main trading partner—with more than 60 percent of Swiss exports going to the EU and nearly 80 percent of its imports coming from the EU—the traditionally independent Swiss have stayed out of the EU and the European Economic Area. The current agreements do not represent a step towards EU membership, and will only take effect once they are also ratified by the 15 EU member states.

Unemployment Low, but Lasts a Long Time in Portugal. Unlike other European countries with relatively inflexible labor markets, Portugal's unemployment rate remained low in the 1980s and 1990s. Portugal and the United States have had the same average unemployment rate over the past 15 years and their current unemployment rates are both about 4 percent. A new study, however, finds that—as in many other European countries—the unemployment pool in Portugal is much more stagnant than in the United States. The average duration of periods of unemployment is three times longer in Portugal than in the United States. The study argues that the stagnancy in the flow of workers into and out of employment in Portugal is due to excessively strong employment protection laws; the OECD consistently ranks Portugal as the country with the highest degree of employment protection among OECD countries. Legislation on collective dismissals has an uncertain effect on the unemployment rate: it can lead to lower layoffs because it imposes a long and costly process on employers, but it can also lead to a reluctance to hire new workers. The authors point out that although labor market inflexibility does not necessarily increase unemployment, in their model it unambiguously reduces overall economic efficiency because it inhibits the sorting process of the labor market.

RELEASES THIS WEEK

Advance Durable Orders

****Embargoed until 8:30 a.m., Friday, May 26, 2000****

Advance estimates show that new orders for durable goods decreased 6.4 percent in April, following an increase of 4.5 percent in March.

Gross Domestic Product

According to revised estimates, real gross domestic product grew at an annual rate of 5.4 percent in the first quarter of 2000.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—The Conference Board (Tuesday)
Leading Indicators (Wednesday)
NAPM Report on Business (Thursday)
Employment (Friday)

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:3	1999:4	2000:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	4.6	5.7	7.3	5.4
GDP chain-type price index	5.2	1.6	1.1	2.0	2.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	5.0	6.9	2.4
Real compensation per hour:					
Using CPI	1.0	1.7	2.0	0.9	0.3
Using NFB deflator	1.5	2.9	4.0	1.8	1.8
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.7	12.5	**13.0**
Residential investment	4.5	4.4	4.4	4.4	4.4
Exports	8.2	10.8	10.8	10.9	**10.9**
Imports	9.2	13.5	13.8	14.0	**14.3**
Personal saving	6.6	1.7	1.5	1.3	**0.4**
Federal surplus	-2.8	1.2	1.4	1.2	**1.9**

	1970-1993	1999	February 2000	March 2000	April 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.1	3.9
Payroll employment (thousands)					
increase per month			27	458	340
increase since Jan. 1993					21615
Inflation (percent per period)					
CPI	5.8	2.7	0.5	0.7	0.0
PPI-Finished goods	5.0	2.9	1.0	1.0	-0.3

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1998	1999	March 2000	April 2000	May 25, 2000
Dow-Jones Industrial Average	8626	10465	10483	10944	10324
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.66	5.68
10-year T-bond	5.26	5.65	6.26	5.99	6.39
Mortgage rate, 30-year fixed	6.94	7.43	8.24	8.15	8.62
Prime rate	8.35	8.00	8.83	9.00	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level**	**Percent Change from**	
	May 25, 2000	**Week ago**	**Year ago**
Euro (in U.S. dollars)	0.907	1.3	-14.3
Yen (per U.S. dollar)	107.5	-1.1	-12.5
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	99.53	-0.5	4.1

International Comparisons [1]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	3.9 (Apr)	3.0 (Apr)
Canada	4.7 (Q4)	6.8 (Mar)	2.1 (Apr)
Japan	0.0 (Q4)	5.0 (Mar)	-0.5 (Mar)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q4)	8.4 (Mar)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.9 (Jan) [2]	3.0 (Apr)

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.