The Levy Economics Institute of Bard College

Report

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New Strategic Analysis

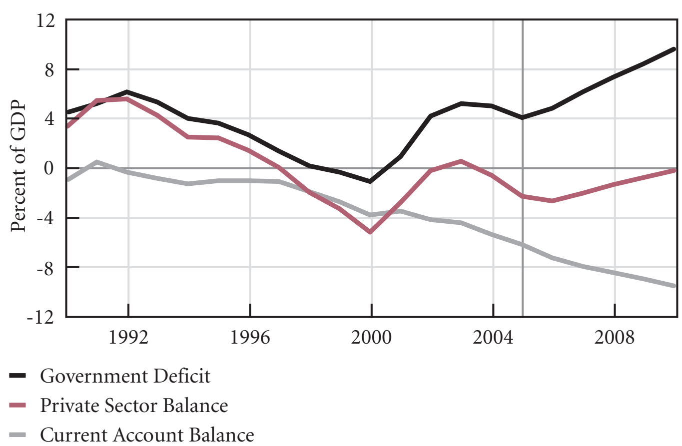
CAN THE GROWTH IN THE U.S. CURRENT ACCOUNT DEFICIT BE SUSTAINED? THE GROWING BURDEN OF SERVICING FOREIGN-OWED U.S. DEBT

DIMITRI B. PAPADIMITRIOU, EDWARD CHILCOTE, AND GENNARO ZEZZA

www.levy.org/pubs/sa_may_06.pdf

The current account balance measures exports minus imports, plus the balance of certain income flows. The new strategic analysis by Dimitri B. Papadimitriou, president of the Levy Institute, and Research Scholars Edward Chilcote and Gennaro Zezza focuses on the role of net income, particularly the interest paid by the United States on U.S. debt held abroad.

Figure 1 Scenario with CBO Growth Path and Slowing Private Sector Borrowing: Main Sector Balances



Sources: Bureau of Economic Analysis and authorsí calculations

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The Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan research organization devoted to public service. Through scholarship and economic research it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

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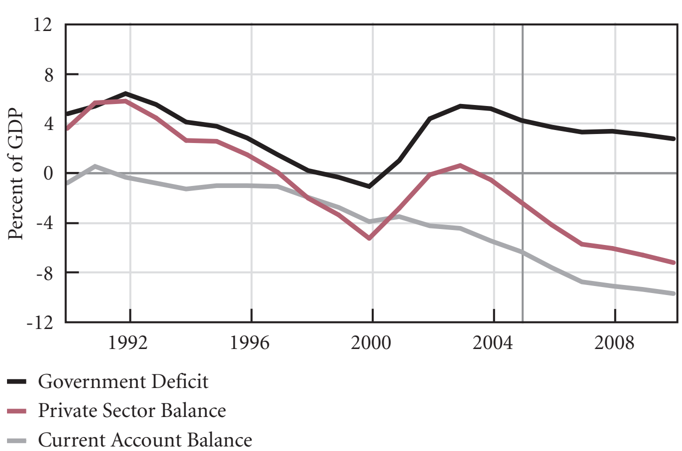
The authors first discuss the continuing debate on the origins and importance of the current account imbalance and the question of whether its resolution will involve widespread economic pain. Many U.S. central bankers believe that the resolution will be relatively benign, as long as policymakers work to keep inflation contained. Asian central bankers instead are especially concerned that problems could arise as the Asian countries, which are a major source of funding for the American deficit, slow their accumulation of U.S. IOUs.

Net income from assets, including interest, is an important component of the current account deficit. Currently, net income is a very small number. This is considered somewhat anomalous, since U.S. liabilities to the rest of the world are nearly $2.5 trillion greater than U.S. assets. Papadimitriou, Chilcote, and Zezza argue that net income will soon become a large negative number. They list three reasons for this claim: first, owing to Federal Reserve policy, interest rates have risen and will most likely continue to rise; second, the United States will soon begin funding more of its debt with longer-term issues, which command higher rates; and third, foreign central banks will soon slow or stop their accumulation of U.S. currency and bond reserves, forcing the U.S. government to offer higher interest rates in order to attract bond buyers. Since all of these factors will raise U.S. costs of borrowing, they will also increase the current account deficit.

Figure 2 **Scenario with CBO GDP Growth Path: Main Sector Balances**



Sources: Bureau of Economic Analysis and authors' calculations

Having analyzed this worrisome trend, the authors report on some updated simulations of the future course of the economy's three main balances. First, they update a previous projection, based on a number of assumptions: 1) a leveling off of consumer and nonfinancial business debt; 2) no devaluation of the dollar or rise in the price of oil; 3) a modest increase in the federal funds rate; and 4) fulfillment of the optimistic projections for economic growth of the Congressional Budget Office (CBO). (See Figure 1.) The authors find that in this set of circumstances, the combined local, state, and federal deficit would have to rise to a record 9 percent of GDP by 2010. The current account balance would fall to negative 9.8 percent of GDP. Since these numbers seem implausible, the CBO's growth projections may be unrealistic. The analysis then covers an alternative scenario (Figure 2), in which private borrowing continues to provide the impetus for economic growth, while the federal deficit remains more contained. In the short run, this scenario may be the more realistic of the two, but it only increases the financial fragility of the U.S. private sector.

Conference

Government Spending on the Elderly

On April 28 and 29 of 2006, scholars met at the Levy Institute to discuss government spending on the elderly. The participants discussed many threats to the well-being of older people. By some measures, there has been a retrenchment of the welfare state in Western Europe. In the United States, the stock market boom of the late 1990s appears to have helped many people prepare for retirement, but one presentation suggested that over 40 percent of today's 56- to 64-year-olds would not have sufficient income when they left the workforce. Participants tended to be concerned either that the Social Security system would soon be insolvent or that it would fall prey to overzealous reformers. In sum, two busy days were spent discussing one of the most important domestic issues of our time. The diverse opinions and ideas presented at the conference are summarized below.

Session 1. Welfare State and the Incentives to Retire

Chair: AJIT ZACHARIAS, LEVY INSTITUTE
Speakers: AXEL BÖRSCH-SUPAN, MANNHEIM RESEARCH INSTITUTE FOR THE ECONOMICS OF AGING, UNIVERSITY OF MANNHEIM; L. RANDALL WRAY, LEVY INSTITUTE, UNIVERSITY OF MISSOURI–KANSAS CITY, AND CENTER FOR FULL EMPLOYMENT AND PRICE STABILITY
Discussants: SERIO NISTICÒ, UNIVERSITY OF CASSINO; RICHARD STARTZ, UNIVERSITY OF WASHINGTON

Börsch-Supan presented a comparative study of European and U.S. welfare states. First, he described the generosity of the range of policies now in force. In comparison with the United States, the European states, especially the Scandinavian countries, spend a large percent of their GDPs on social welfare programs. The EU countries devote widely varying percentages of their GDPs to social programs. A retrenchment of the welfare state occurred in the European Union in the early 1990s. When measured against population, however, rather than against GDP, the welfare state in these countries appears to have grown since then. The nations in Börsch-Supan's study appear to emphasize help for the elderly to widely varying degrees; Italy spends about 70 percent of its entire social budget on the elderly, while Ireland spends less than a third of its social budget on this group. Börsch-Supan found little evidence that spending on the elderly "crowds out" programs for the young. If anything, a positive correlation arose between the generosity of a government toward its young and that government's generosity toward its elderly. Using a statistical test, Börsch-Supan found a number of factors to be important in determining the generosity of one welfare state compared with that of others: the size of the elderly population, the political preferences of citizens, and the incentives to retire or receive disability checks.

Wray was more optimistic than some other speakers about the financial wherewithal of the U.S. government to pay for Social Security benefits in the distant future. He emphasized that the real challenge in providing for the elderly will be to ensure that actual inflation-adjusted output is sufficient—a question that will depend more on the growth of output per worker (productivity) than on demographic trends. The Social Security trustees' projections of productivity growth have probably been somewhat too conservative. To support his optimistic view, Wray pointed out that the ratio of dependent children to workers will fall in the coming years, even as the elderly make up a larger and larger proportion of the population. It is interesting to note that because of large cohorts of children, people of working age made up a smaller percentage of the population in some of the years from 1965 to 1985 than they will in the future. Moreover, favorable trends in the portion of the working-age population that is actually employed (possibly spurred by pro-growth economic policies) could help house, clothe, and feed the elderly. It would be more beneficial to attempt to increase employment and productivity than to incite conflicts between generations over a supposedly fixed economic pie. Although each individual household needs to prepare for its retirement by accumulating financial assets, the main determinant of the well-being of the elderly population as a whole will be GDP in future years; this is due to the fact that society cannot eat its securities.

Ajit Zacharias

Session 2. Aspects of Economic Well-Being and Gender Disparities among the Elderly

Chair: GREG HANNSGEN, LEVY INSTITUTE
Speakers: AJIT ZACHARIAS, LEVY INSTITUTE; LOIS B. SHAW, INSTITUTE FOR WOMEN'S POLICY RESEARCH
Discussants: ROBERT HAVEMAN, UNIVERSITY OF WISCONSIN–MADISON; CAREN GROWN, LEVY INSTITUTE

Zacharias's paper, which was coauthored by Edward N. Wolff and Hyunsub Kum, examined the well-being of the elderly using the Levy Institute Measure of Economic Well-Being (LIMEW). The LIMEW has been summarized in the *Report* previously (October 2004, p. 3) and is made up primarily of six components—earnings, pensions, income from wealth, transfers, public consumption, and household production—less taxes. Hence,

Lois B. Shaw

Caren A. Grown

it is much more comprehensive than all Bureau of the Census measures. While nonelderly households receive more well-being from base income (which excludes "transfers" such as Social Security), public consumption (including education), and household production, than do elderly households, the elderly enjoy more well-being, on average, from wealth, transfers, and pensions, and they pay less taxes than the nonelderly. It is interesting to note that overall, the elderly are net beneficiaries of government activity, whereas the nonelderly lost $4,500 per year on average owing to the effects of government in 2001. Mean LIMEW for the elderly grew by 35 percent from 1989 to 2001; by way of comparison, LIMEW for the nonelderly grew by only 20 percent. The gap in LIMEW between whites and nonwhites is greater than the corresponding gap in less comprehensive measures of well-being. Also, a large gap separates married couples and single females, even after taking into account differences in household size. Finally, the degree of inequality that exists among the elderly is much greater than among the nonelderly.

Shaw discussed policy issues relating to people of "young" old age and "old" old age. She called into question proposals to improve the finances of the Social Security system by deferring the retirement age. Discrimination against older workers is common; late retirement is difficult for those with physically demanding jobs (including many jobs in the service sector); and early retirements are often the result of corporate downsizing efforts, not the choice of the worker. Another problem with keeping the "young" old in the paid workforce is that often people of this age, especially women, bear the responsibility of caring for older relatives. In fact, such care is sometimes cited as one solution to rising Medicaid costs. The care needs of the "old" old constitute a policy issue in themselves. As life spans increase, more elderly people are reaching an age when disabilities such as poor vision crop up, often necessitating extra help. Providing all of the needed care may be more difficult for the baby boom generation than for past cohorts, as the baby boomers had relatively few children and are more likely to be divorced or to have never been married than previous generations. Shaw concluded her presentation with a very positive portrayal of the continuing care facility in which she lives.

Session 3. Changing Patterns of Retirement Behavior

Chair: CAREN A. GROWN, LEVY INSTITUTE
Speakers: KAREN E. SMITH, URBAN INSTITUTE; MICHAEL HURD, RAND CORPORATION
Discussants: LUCIE G. SCHMIDT, WILLIAMS COLLEGE; DANIEL L. THORNTON, FEDERAL RESERVE BANK OF ST. LOUIS

In a paper written with Barbara Butrica and C. Eugene Steuerle, Karen E. Smith studied the potential effects of later retirement on the retirement income of individuals and the solvency of the Social Security system. The three economists used DYNASIM, which simulates the future income of 100,000 individuals from the 1990 to 1993 Survey of Income and Program Participation, a federal survey that followed the same participants over time. They altered their baseline simulations by assuming that individuals retire later than currently projected, and by revising the "normal" and "early" retirement ages for the Social Security retirement program. The authors used two types of hypothetical

Teresa Ghilarducci

Zvi Bodie

changes: first, they experimented with individual choices regarding retirement age, keeping program rules constant; then, they examined the likely effects of increasing the retirement ages set by Social Security rules; and finally, they combined the two types of changes. They found that if everyone delayed retirement by one year, and used his or her additional income to purchase an annuity at retirement, average retirement income would increase by $2,402 per year. A five-year increase in the average age of retirement would net workers $14,888 per year over currently projected levels. Such an increase in retirement age would also reduce the projected 2045 Social Security program deficit by 29 percent. If an enhanced work effort were combined with five-year increases in the statutory retirement ages for Social Security (for both early and normal retirement), the effect on the program's finances would be enormous: The projected deficit in 2045 would become a surplus of $377 billion.

In standard economic models of consumption, any increase in income is used to increase consumption over a period of multiple years. For example, if someone wins a lottery, he or she not only spends more on consumption goods that year, but also saves more that year and consumes more later in life. Furthermore, since part of an increase in lifetime income might be left at the end of life, owing to increased savings, there is a chance that the lottery winnings will cause an increase in bequests. Hurd, in an article written with Li Gan and Guan Gong, tested this theory as it applies to higher Social Security benefits. In the model, individuals are assumed to be single and uncertain only about when they will die. They receive "utility" (in rough translation, happiness) from the goods and services they consume over their lifetimes, and also possibly from the amount of money they leave to their children. The key finding of the paper is that, according to the model, when individuals receive larger Social Security benefits, they reduce their bequests, or if they do increase them, it is only by an insignificant amount.

Session 4. Interaction between Private and Public Provisioning

Chair: W. Ray Towle, Levy Institute

Speakers: Teresa Ghilarducci, University of Notre Dame; James Marton, University of Kentucky; and Stephen Woodbury, Michigan State University

Discussants: Zvi Bodie, Boston University; Barbara Wolfe, University of Wisconsin–Madison

One reason for the decline in the saving rate of households, according to Ghilarducci, is the decline in the role of pension saving. Here, a paradox presents itself: even as pension coverage has fallen, total spending on pensions, and especially government tax breaks for retirement schemes, has risen. Ghilarducci argued that the explanation may lie in the fact that retirement spending is increasingly concentrated on higher-income workers, to the exclusion of the middle class. She also argued that declining pension coverage can, in large part, be attributed to corporate efforts to reduce costs. Firms often switch from conventional defined-benefit pension programs to 401(k)s in full awareness that workers tend to underutilize the latter sort of benefit. Ghilarducci made several points regarding claims by some that retirement income deficiencies could easily be solved

Jagadeesh Gokhale

by encouraging seniors to work longer. If this were the case, standard economics would lead one to ask why seniors would need much encouragement to keep working. Perhaps they don't mind living on a smaller income, if so doing enables them to enjoy more time off. Also, many seniors may not have the option of staying in their current jobs instead of retiring; rather, they might have to choose between retirement and lower-paid, lower-status work, such as retail sales.

Marton and Woodbury examined how privately provided retiree health benefits affect labor supply. Two types of insurance are involved: First, since Medicare does not begin until age 65, some employers offer health benefits to retired workers under that age; second, many employers provide additional health benefits to workers who are already old enough to qualify for Medicare. Data show that fewer retirees currently receive health insurance coverage from their former employers than in the recent past: About 20 percent of private employers offered benefits in 1997, a figure that declined to 13 percent in 2003. Previous studies have found that access to retiree health benefits increases the likelihood of retirement. Marton and Woodbury were able to study the issue using several "waves" of the Health and Retirement Survey (HRS), a study that followed a single group of older workers and retirees over time. They looked at several factors thought to affect the retirement decision—in addition to the availability and cost of retiree health benefits—including pension coverage, expected entitlement to Social Security benefits, physical health, and an array of demographic variables. In line with a previous study, Marton and Woodbury found that older workers who were covered by retiree health benefits in 1992 were 10 percentage points more likely to be retired in 1996 than those not covered. On the other hand, Marton and Woodbury estimated that the impact of employer cost sharing of retiree health premiums was much larger than an earlier study had found. An extension of the estimates to more recent years (1998, 2000, 2002, and 2004) shows that when the labor market deteriorated in the recession of 2001, workers became more inclined to take advantage of retirement health benefits than they had in previous years.

Session 5. Budgetary and Macroeconomic Implications of Aging

Chair: HYUNSUB KUM, LEVY INSTITUTE

Speakers: SHRIPAD TULJAPURKAR, STANFORD UNIVERSITY; JAGADEESH GOKHALE, CATO INSTITUTE

Discussants: CLARK BURDICK, SOCIAL SECURITY ADMINISTRATION; STEPHANIE A. KELTON, UNIVERSITY OF MISSOURI–KANSAS CITY

The finances of Social Security depend ultimately on mortality trends, interest rates, economic growth, and other variables subject to the influence of chance. Tuljapurkar has constructed a probabilistic forecasting model, which, by explicitly including random events, allows him to estimate confidence intervals for various demographic variables and the balance of the Social Security trust fund. He reported that predicting fertility rates was subject to a much greater amount of uncertainty than projecting mortality rates. Assuming that Social Security laws are not changed, Tuljapurkar projects a 50 percent probability that the system's deficit will exceed 5 percent of total income over the next 75 years. Using his model, he calculated that, with moderately good luck, the trust fund would still have a positive balance in 2050; in the bad-luck scenario, the balance would fall to around negative 30 percent of GDP by that date. Tuljapurkar next analyzed the effects of several policy changes on the probability that the system would become "insolvent" within 50 years. A hypothetical tax increase of 1 percent raises the probability of solvency from zero to 40 percent. If, in addition, 20 percent of the trust fund were invested in the stock market instead of government bonds, the solvency probability would rise to 60 percent. A gradual increase in the retirement age to 69, in combination with a tax hike, would boost the chance of solvency to 80 percent.

The actuarial balance of the Social Security system is thought by many to be an important figure because it allows

Dimitri B. Papadimitriou

one to estimate how much benefits would have to be cut, or taxes raised, to bring the program to solvency. The actuarial balance is the difference between income and program costs divided by taxable payroll, over a specific evaluation period. The trustees of the program have recently estimated that, for the coming 75-year period, the balance is a negative 1.92 percent. Hypothetically, this means that if payroll taxes were immediately raised by 1.92 percentage points, the Social Security trust fund would remain above zero for 75 years. Using this sort of 75-year model, the trustees have also estimated that higher assumptions about the rate of GDP growth in the future lead to more optimistic estimates of the actuarial balance. In his presentation, Gokhale cited alternative estimates of the effects of higher growth rates over an infinite horizon, with future dollars discounted by a rate of interest. Over an infinite period, higher projections of economic growth may lead to *worse* actuarial balances. The reason is that as wages grow, not only do anticipated payroll tax revenues rise, but so do future benefits.

Session 6. Retirement Security: Problems and Prospects

Chair: DIMITRI B. PAPADIMITRIOU, LEVY INSTITUTE

Speakers: EDWARD N. WOLFF, LEVY INSTITUTE AND NEW YORK UNIVERSITY; MELISSA M. FAVREAULT, URBAN INSTITUTE

Discussants: BROOKE HARRINGTON, BROWN UNIVERSITY; ROBERT K. TRIEST, FEDERAL RESERVE BANK OF BOSTON

In previous work, Wolff found that the proportion of households with a member who was about to retire that would be unable to replace half of their preretirement income rose from 1989 to 1998. In his presentation, Wolff reported on new work regarding the adequacy of Americans' retirement preparation as of 2001. Wolff reported that the percentage of Americans aged 56 to 64 who could expect to receive retirement incomes of less than double the poverty level declined from 41 percent in 1989 to 27 percent in 2001. Moreover, when adequate retirement income was defined as half of preretirement income, more people were ready for retirement in 2001 than in 1989. These calculations were based not only on individual net worth and expected pension benefits, but also on Social Security payments. Wolff attributed the improvements to the strong economy between 1998 and 2000, in particular the strong stock market. Huge disparities among ethnic groups existed: The mean retirement income of African Americans and Hispanics was projected to be only one-fourth of that of non-Hispanic whites. Single women had an expected retirement income of only 29.4 percent of that of married couples.

Social Security plays a vital role in raising the retirement incomes of many seniors above the poverty level. Nevertheless, Social Security benefits are based upon lifetime earnings, and many low-income workers receive very low benefits from Social Security; as a result, poverty is persistent among the elderly. Almost 9 percent of Social Security beneficiaries over 65 are living in poverty, according to official statistics. The existing means-tested cash program for the aged, Supplemental Security Income (SSI), does provide some income for this group; however, its payment levels are often below the poverty level, and the program has stringent eligibility requirements, including low limits on nonexcluded assets. Favreault's paper, coauthored with Gordon B. T. Mermin and C. Eugene Steuerle, is a look at proposed minimum Social Security benefit programs aimed at improving the economic situation of low-income seniors. Although these programs would be aimed at the poor, they would be free of some of the onerous eligibility requirements of SSI, which means that the government would be able to help more people while imposing less of a "welfare stigma." The key part of the paper is a report of a series of computer simulations of the effects of a minimum benefit. It turns out that the more generous proposals would have a big impact on poverty rates, reducing the number of Social Security beneficiaries over 62 living in poverty by up to 30 percent—even when other benefit cuts are made to preserve the trust fund.

New Policy Notes

Twin Deficits and Sustainability

L. RANDALL WRAY

Policy Note 2006/3

www.levy.org/pubs/pn_3_06.pdf

Today, numerous commentators worry that the country may be going "bankrupt." Years of budget and private sector deficits have resulted in a huge amount of debt to the rest of the world, and many have made the observation that this situation is unsustainable. L. Randall Wray's new policy note investigates these claims. First, he observes that many people were making similar statements in the mid- to late-1980s. The nation's savings rate did eventually climb to more normal levels by the early part of the next decade, but this development only brought recession. Japan, whose high saving rates had been hailed as an economic model for the rest of the world, fell into a much deeper recession. In fact, private sector surpluses track the unemployment rate closely, suggesting that when consumers take out their credit cards, the economy benefits in many ways. However, critics of the twin deficits are correct in some sense when they say that the current round of deficits is not sustainable. While there is no such thing as a "national budget constraint," consumers cannot handle increasing debt loads forever. Moreover, federal budget deficits are largely a product of conditions in the private sector: When the economy is strong, tax revenues rise, and some forms of social spending decline. For this reason, current trends in the government debt will eventually turn around, too.

Debt and Lending: A *Cri de Coeur*

WYNNE GODLEY and GENNARO ZEZZA

Policy Note 2006/4

www.levy.org/pubs/pn_4_06.pdf

This new policy note by Distinguished Scholar Wynne Godley and Research Scholar Gennaro Zezza investigates the reliance of the U.S. economy on heavy doses of private borrowing. The authors first challenge the realism of Congressional Budget Office growth projections. Godley and Zezza estimate that in order for the CBO to be correct in its forecast that growth will remain fairly strong during the next five years, the current account deficit would have to rise to over 8 percent by 2010. And, perhaps more disturbing, private net lending would have to increase to over 20 percent of disposable income.

The authors argue that such a continuing explosion of lending would be unlikely. To find more plausible numbers for net lending, they look at four scenarios for the path of private *debt*. They find that if debt stabilizes, or even grows at a slower rate than the CBO numbers imply, the consequences for *lending* would be dramatic. This is because any net lending leads to an increase in the stock of outstanding debt. In turn, a drop-off in lending would have serious implications for GDP growth, as suggested by the close historical relationship between these two variables. Using the Levy Institute's macroeconometric model, Godley and Zezza estimate that in the low-lending scenarios, average economic growth could drop as low as 1.4 percent per year until 2010.

New Public Policy Brief

Can Basel II Enhance Financial Stability? A Pessimistic View

L. RANDALL WRAY

Public Policy Brief No. 84

www.levy.org/pubs/ppb_84.pdf

In the 1950s and 1960s, the joke goes, the banker's motto was "three-six-three": pay 3 percent on liabilities, charge 6 percent on assets, and hit the golf course by 3 p.m. The fact was, in those days, few banks failed. That changed for good in the 1970s and 1980s, when recessions, financial innovations, inflation, and deregulation roiled the industry. One byproduct of the banking and savings and loans crises of those days was the 1992 Basel Accord, an international agreement that set minimum ratios of bank capital to assets.

As Senior Scholar L. Randall Wray of the University of Missouri–Kansas City and the Center for Full Employment and Price Stability points out in this new brief, the old Accord soon began to seem outdated. It imposed different minimum capital ratios for different classes of assets. Bankers sometimes tried to game the regulations by acquiring the riskiest types of assets allowable in each category. Banks also developed sophisticated models to predict the riskiness of their portfolios, and these models often indicated that the levels of capital imposed by the Accord were not appropriate.

Basel II, which, like the first accord, was developed by the Basel Committee on Banking Supervision, consists of three pillars: first, the addition of many more risk categories, with varying capital ratios; second, enhanced supervision by host-country governments; and third, requiring banks to disclose more information, so that potential investors and depositors can avoid institutions that take excessive risk. Many governments are phasing in the new rules, but the United States has not fully adopted them.

Wray argues that while Basel II will play a positive role, it cannot address the root causes of financial instability. Hyman P. Minsky, the late Levy Institute scholar, taught that cycles of financial boom and bust are natural to the capitalist system. In a period of financial tranquility, bankers and businesspeople become complacent and overoptimistic, as memories of hard times fade. They take greater and greater risks, setting the stage for an eventual crisis. Regulations of the type imposed by Basel II can do only so much to prevent such crises. First, regulations tend to be backward looking: they are based on recent experience, which can be a misleading guide to an uncertain and unprecedented future. Moreover, crises result more often from events such as central bank actions and currency devaluations, over which banks have little control, than from inadequate capital. Basel II, says Wray, will almost surely fall short of its ambitious objectives.

New Working Papers

Tinbergen Rules the Taylor Rule

THOMAS R. MICHL

Working Paper No. 444

www.levy.org/pubs/wp_444.pdf

In a new working paper, Thomas R. Michl of Colgate University examines the role of monetary policy in a simple heterodox economic model. It is currently fashionable to model the central bank using a "Taylor Rule," which sets interest rates as a function of several variables, most importantly the inflation rate. In his academic writings, current Fed Chairman Ben S. Bernanke has advocated the real-world adoption of a rule-based approach to monetary policy. Does such a rule produce good macroeconomic outcomes?

In the model Michl uses to answer this question, inflation originates in the product market and is propagated to the labor market by the efforts of workers and firms to maintain the level of the real wage. Only capitalists, not workers, save. In addition, in one model, the labor supply adjusts depending upon demand for workers. The model avoids implausible assumptions about firms changing the ratio of various ingredients in their production process; this feature makes capacity utilization issues relevant.

Michl begins by assuming that the central bank targets the inflation rate only, increasing interest rates when inflation is high, regardless of other economic variables. He shows that if the sensitivity of policy to inflation is too great, instability or cycles will result. In a model constrained by a given rate of growth of the labor force, Michl finds that the rate of employment (the percentage of the workforce employed) is path dependent; that is, the equilibrium level depends upon the path taken prior to reaching equilibrium. The implication is that if the central bank adopts inflation targeting during a time when unemployment is high, mass unemployment could be "locked in" for the long term.

Adding a central bank employment target does not change the path-dependent character of the model. One of the lessons of the paper, which is consistent with the views of renowned econometrician Jan Tinbergen, is that the best the monetary authorities can hope to accomplish is to meet a target for a certain combination of employment and inflation levels.

A Random Walk Down Maple Lane? A Critique of Neoclassical Consumption Theory with Reference to Housing Wealth

GREG HANNSGEN

Working Paper No. 445

www.levy.org/pubs/wp_445.pdf

According to neoclassical economics, the key aspects of an asset are its risk and return. In the standard theory of consumption, all forms of wealth are lumped together, and it is assumed that they are liquidated and used for consumption at a slow, steady rate. But, Research Scholar Greg Hannsgen asks in a new working paper, can homes be analyzed in the same way as all other forms of wealth? If not, the implications for neoclassical theory would be profound, as housing wealth constitutes a staggeringly large proportion of all wealth of middle-class Americans.

Behavioral economists have gathered a great deal of evidence that people treat different forms of wealth in different ways. For example, many people who know they have difficulty controlling their spending deliberately place some money "off limits," in forms that cannot easily be spent. This violates the neoclassical prediction that consumers should spend an equal proportion of any new wealth they receive.

Some violations of the theory of consumption have even been recognized by its founders. When wealth is not held in a liquid form, it cannot always be used for consumption. Certainly, until recently, housing partly fit this description: One could not tap the wealth held in one's home easily or cheaply, as home-equity loans were less readily available.

Hannsgen points out that changes in the way we treat different forms of wealth occur constantly, as institutions evolve. In recent years, the evolution of institutions in the United States has been strongly influenced by free market–oriented models such as neoclassical consumption theory. According to this theory, all forms of wealth should be treated identically; thus, favorable tax treatment, for example, should not be available for some types of assets and not others. Hannsgen refers to this approach as the homogeneity thesis. The liquidity thesis, on the other hand, suggests that people should be free to save and consume their wealth when they see fit; otherwise, the economic system will be inefficient. One example of the application of these principles is the recent series of reforms of the banking and thrift industries in the United States.

Hannsgen sketches his own analysis of the role of housing wealth in economic life. He argues that housing is different from financial wealth in part because it has a social role; in contrast to a stock or bond, one cannot sell one's home without changing neighbors, schools, and the "face" the family presents to the community. In light of this special role, certain norms are appropriate for buying, selling, and caring for homes and communities. For example, a consumer often does not make trade-offs involving housing as readily as he or she might make other economic transactions.

Feminist-Kaleckian Macroeconomic Policy for Developing Countries

STEPHANIE SEGUINO and CAREN A. GROWN

Working Paper No. 446
www.levy.org/pubs/wp_446.pdf

This new working paper explores the connections between economic growth, liberalization, and gender equality and suggests some new policies aimed at improving the status of women worldwide. Authors Research Associate Stephanie Seguino of the University of Vermont and Senior Scholar Caren A. Grown, codirector of the Levy Institute program on gender equality and the economy, point out that one side effect of liberalization has been a "feminization of foreign exchange earnings": In developing countries, it is often women who have taken the majority of low-paying jobs in export sectors. However, despite the high demand for women's labor, the gap between men's and women's wages has been persistent in most countries. Also, as women have participated increasingly in the paid workforce, they have not enjoyed a commensurate reduction in the amount of time they must work in their own households.

Moreover, women have felt the adverse macroeconomic effects of globalization. As economies around the world have become oriented toward export markets, the need for governments to maintain domestic demand has lessened. Moreover, financial liberalization has forced many countries to adopt very stringent monetary and fiscal polices in order to defend their currencies. Because women are more likely than men to be unemployed, they often bear the brunt of weak domestic demand.

Seguino and Grown offer a set of policies that might help countries achieve stronger growth and reduce gender inequality. Their vision is of "wage-led growth," which would bring full employment and rising productivity growth. They would combat the deflationary bias of liberalized economies by giving firms incentives to produce products whose demand is relatively insensitive to price changes and whose quality matters. Industries that produce such goods offer the best chance of permitting increases in women's wages. In such a scenario, firms might have incentives to improve their productivity in order to reduce costs, rather than keeping wages at an absolute minimum. This might, in turn, set up a virtuous circle of rising wages and expanding domestic markets. This is not a pie-in-the-sky vision; parts of the strategy have worked well in South Korea and elsewhere. The authors summarize by saying, "For a country to reorient export and investment to support equity with growth requires an expanded role for government in managing economic outcomes."

The authors believe that action is needed at the international level to make this approach feasible for individual developing nations. Specifically, WTO rules would have to be changed, and governments in the developed world would have to redistribute income to their less well-off residents in order to expand import markets. The authors argue that even "progressive" policies will not guarantee better lives for women; a specifically gender-oriented set of policies is needed.

Household Wealth and the Measurement of Economic Well-Being in the United States

EDWARD N. WOLFF and AJIT ZACHARIAS
Working Paper No. 447
www.levy.org/pubs/wp_447.pdf

Economists and journalists frequently make claims about income inequality among Americans. But the degree of inequality and its proper remedies depend critically on how income is measured. Senior Scholars Edward N. Wolff of New York University and Ajit Zacharias argue in a new working paper that adjusting income for differences in net worth reveals important information about the true nature of inequality.

Wolff and Zacharias are part of a team at the Levy Institute that has developed a new measure of income called the Levy Institute Measure of Economic Well-Being (LIMEW). Income from wealth is an important part of that measure. In this paper, the two scholars concentrate on the effects of merely adding income from wealth to a standard measure of income. Income from wealth is measured the same way in this paper as it is in LIMEW. Income from homes is the rent they could command on the open market. Income from financial wealth is measured as the amount of money the household could hypothetically obtain each month if the wealth were converted to an annuity.

Wolff and Zacharias identify a number of trends from the 1980s and 1990s in their measure of income, which they call wealth-augmented income. They find that the level and distribution of income are greatly affected by the inclusion of wealth. Wealth-augmented income increased faster from 1989 to 2000 than standard money income. Also, because wealth is concentrated in few hands, the wealth-augmented measure shows more economic inequality than standard money income. By either measure of income, inequality increased from 1983 to 2001.

Wolff and Zacharias also tackle the common impression that those with high earnings have replaced those who make money from investments at the top of the economic ladder. Income from wealth accounted for 46 percent of the income of those in the top 1 percent of the distribution of wealth-augmented income.

The inclusion of wealth in income also affects differences in the income of different social and demographic groups. In particular, wealth-augmented income is more unequally divided between African Americans and whites than standard income, a finding that suggests racial gaps are wide. The addition of income from wealth also helps older age groups relative to the young, as the former have generally accumulated some savings for retirement.

The authors conclude that in order to fight inequality, policymakers will have to deal with inequality of wealth, not just income as the term is commonly defined.

Gibson's Paradox II

GREG HANNSGEN
Working Paper No. 448
www.levy.org/pubs/wp_448.pdf

Economists and other analysts are currently worried that, as the economy strengthens, inflation may reignite. It is often thought that the Federal Reserve can inoculate the economy against inflation by preemptively raising interest rates, and that is what the Fed has been doing. But interest payments are a cost to businesses, and when costs increase, firms often raise prices. Could interest rate hikes be the wrong medicine for inflation?

In a new working paper, Research Scholar Greg Hannsgen constructs a model in which interest payments are a cost of business to firms to find out how such an artificial economy might respond to the Fed's anti-inflationary policy. This model is a much more elaborate version of one included in an earlier paper by Hannsgen.

The model has several interesting features. First, Hannsgen uses a Taylor rule to describe Fed policy making. According to this rule, the Fed sets interest rates as a function of how far inflation and output deviate from their target levels. In particular, it is assumed that the Fed gradually raises its interest rate when inflation is above its target. A second aspect of Hannsgen's model is that investment depends upon the rate of change, and not just the level, of the interest rate. Hannsgen cites the example of an episode in the late 1970s and early 1980s, during which interest rate hikes led to financial difficulties. Finally, Hannsgen rejects standard supply-demand theories of pricing, arguing that firms base their prices solely upon unit costs.

In solving his model, Hannsgen finds that anti-inflationary Fed policy can indeed destabilize the economy; moreover, it can contribute to cycles in inflation and output. Specifically, if the Fed reacts either too strongly or too weakly to inflation, the economy will be unstable. However, Hannsgen proves that his model can generate cycles under certain conditions, a finding that modifies his stability results. Two types of cycles are possible. The economy may be drawn toward an orbit that continues forever. Alternatively, a "corridor of stability" may exist. In that case, if the economy's path starts within the corridor, it is drawn toward a central equilibrium point. Paths starting outside the corridor would spiral outward, never approaching an equilibrium point.

A simple model can offer only so much insight into our complex economy. But Hannsgen's model shows a basic chain of events that might also occur in a more complete model: the Fed raises interest rates; this raises firms' costs; firms raise their prices; and finally, the Fed again hikes rates.

The Temporal Welfare State: A Cross-national Comparison

JAMES MAHMUD RICE, ROBERT E. GOODIN, and
ANTTI PARPO
Working Paper No. 449
www.levy.org/pubs/wp_449.pdf

An earlier version of this paper was presented at the Institute's conference on "Time Use and Economic Well-Being," on October 28, 2005. Please see the summary of this presentation on p. 18 of the January 2006 *Report*.

Levy Institute News

Symposium: Gender Equality, Tax Policies, and Tax Reform in Comparative Perspective

In an important symposium that took place at the Levy Institute on May 17 and 18, scholars and policymakers from around the world discussed the gender aspects of taxation. The October 2006 *Report* will contain a complete summary of all of the presentations given at the symposium.

New Positions for Levy Institute Scholars

On June 1, Levy Institute President Dimitri B. Papadimitriou announced several personnel changes, which will take effect July 1. Ajit Zacharias, who leads the program on the distribution of income and wealth, and the Levy Institute Measure of Economic Well-Being, is now a senior scholar. Edward Chilcote has resigned to return to the private sector. Greg Hannsgen, formerly the editor of various Institute publications, has become a research scholar, assuming Chilcote's responsibilities as a member of the macromodeling team. Hannsgen will continue to edit the *Report* until a successor is named.

New Research Associates

Jacques Silber is a professor of economics at Bar-Ilan University, Israel, who specializes in income inequality and poverty, as well as discrimination and segregation in the labor market. At Bar-Ilan he chaired the Department of Economics from 1993 to 1995 and was a member of the Academic Executive Committee from 1998 to 2000. He has held various visiting teaching positions at the University of Connecticut; University of Southern California; University of California, Los Angeles; University of Geneva; University of Nice-Sophia-Antipolis; Université du Maine; University of Aix-Marseille; Universitat Autònoma de Barcelona; the MILE Program at the University of Bern, Switzerland; University of Coimbra, Portugal; and Christian Albrechts University of Kiel, Germany. He was also a research scholar at Yale University and a visiting scholar at the World Institute for Development Economics Research in Helsinki and at the International Poverty Centre in Brasilia.

Silber is the author of more than 80 papers and articles, which have been published in international academic journals including *Quarterly Journal of Economics*, *Review of Economics and Statistics*, *International Economic Review*, *European Economic Review*, and *Economics Letters*. His books include *Handbook on Income Inequality Measurement*, with a foreword by Nobel laureate Amartya Sen (Kluwer Academic Publishers 1999), and *The Measurement of Segregation and Discrimination in the Labor Force*, coauthored with Yves Flückiger (Physica-Verlag 1999). He is editor-in-chief of the *Journal of Economic Inequality* and of a book series, Economic Studies in Inequality, Social Exclusion and Well-Being (both published by Springer). He has also edited special issues of the *Journal of Econometrics*, *Research on Economic Inequality*, and *Economica*.

Silber holds degrees in international relations from the Institut d'études politiques, in demography from the Institut d'études démographiques, and in economics from the Faculté de droit et de sciences économiques, University of Paris. He also holds an M.A. and a Ph.D. in economics from the University of Chicago.

Branko Milanovic is the lead economist in the World Bank Research Department, a unit dealing with poverty, income distribution, and household surveys. He is also a senior associate at the Carnegie Endowment for International Peace in Washington and an adjunct professor at the School for Advanced International Studies, John Hopkins University, Washington, D.C.

Milanovic's research focuses on the methodology and empirics of inequality, poverty and social policy in transition economies, and globalization and inequality. His recent publications include *Worlds Apart: Measuring International and Global Inequality* (Princeton University Press 2005); *Income and Influence: Social Policy in Emerging Market Economies* with Ethan Kapstein (Upjohn 2003); "True World Income Distribution, 1988 and 1993: First Calculations Based on Household Surveys Alone," *Economic Journal* (2002); and *Income, Inequality, and Poverty during the Transition from Planned to Market Economy* (World Bank 1998).

Milanovic holds a Ph.D. in economics from the University of Belgrade, Serbia.

Recent Levy Institute Publications

LEVY INSTITUTE MEASURE OF ECONOMIC WELL-BEING

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EDWARD N. WOLFF, AJIT ZACHARIAS, and HYUNSUB KUM
May 2005

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EDWARD N. WOLFF and AJIT ZACHARIAS
March 2005

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No. 449, May 2006

Gibson's Paradox II
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No. 448, May 2006

Household Wealth and the Measurement of Economic Well-Being in the United States
EDWARD N. WOLFF and AJIT ZACHARIAS
No. 447, May 2006

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STEPHANIE SEGUINO and CAREN A. GROWN
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GREG HANNSGEN
No. 445, April 2006

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THOMAS R. MICHL
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DIMITRI B. PAPADIMITRIOU
No. 442, February 2006

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