The Jerome Levy Economics Institute of Bard College

# Summary

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The Jerome Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan, independently funded research organization devoted to public service. Through scholarship and economic forecasting 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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## Letter from the Executive Director

*To our readers:*

*This issue of the* Summary *includes activities in all four of our research programs and in special projects. In the program on employment and labor market structure Senior Scholar Joel Perlmann gave a seminar on Census Bureau problems in classifying race and measuring the nation's racial distribution. He also organized a symposium to discuss the economic progress and social integration of immigrants and their children. We summarize three working papers. Research Associate David R. Howell and Elizabeth J.*

*Mueller, both of the Robert J. Milano Graduate School of Management and Urban Policy of the New School for Social Research, find that immigration has significant negative effects on African American earnings in some jobs in New York City. Research Associate Barry Bluestone, of the University of Massachusetts Boston, and Stephen Rose, of the Educational Testing Service, find that the existence of more slack in the labor market than official unemployment rates indicate has consequences for policies based on an inflation-unemployment trade-off. Visiting Scholar Malcolm Sawyer, of the University of Leeds, examines the effects of monetary policy on the distribution of income and barriers to full employment.*

*One working paper is summarized in each of the programs on restructuring in the financial services sector, international trade and competitiveness, and federal budget policy. Cambridge University Visiting Scholar Andrew Paulson makes the case for caution before Europeans proceed to monetary union. Beth Almeida, of the Center for Industrial Competitiveness, University of Massachusetts Lowell, finds that U.S. firms in aircraft engine manufacturing lost share in the international market because of their failure to invest in integrated organizational learning and collaboration between management and the shop floor. Malcolm Sawyer refutes the case for separating the government budget into capital and current accounts.*

*Three working papers and a book chapter are summarized under special projects. Philip Arestis, of the University of East London, and Malcolm Sawyer advocate a return to Keynesian economic policies to secure full employment. Research Associate Karl P. Widerquist and Michael A. Lewis, of the School of Social Work, State University of New York at Stony Brook, discuss the advantages of a guaranteed income in combating a variety of causes of poverty. Distinguished Scholar Wynne Godley, in both an Institute working paper and a chapter in a new book, discusses his use of a sophisticated computer simulation to examine an uncertain economy in which production takes place in real time.*

*As always, I invite your comments on the* Summary.

*Dimitri B. Papadimitriou*
*Executive Director*

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# Program: Employment Policy and Labor Market Structure

## Summaries of New Working Papers

### The Growth in Work Time and the Implications for Macro Policy
Barry Bluestone and Stephen Rose
Working Paper No. 204, August 1997

In May 1997 the official unemployment rate was 4.8 percent, the lowest in 24 years. Not long ago most economists would have considered such an unemployment record impossible to achieve without igniting a cycle of wage-led inflation. Yet, in the first quarter of 1997 prices rose at only a 1.8 percent annual rate; some regional labor markets have maintained local unemployment rates of 4.0 percent without any sign of upward wage pressure. Can unemployment go even lower before prices begin to rise? Research Associate Barry Bluestone, of the University of Massachusetts Boston, and Stephen Rose, of the Educational Testing Service, think that it can.

The logic behind the inflation-unemployment trade-off is that at a low unemployment rate unused capacity in the workforce is virtually exhausted; any attempts by firms to increase output will bid up wages and therefore prices, eventually shrinking investment and leading to a recession. However, according to Bluestone and Rose, to the extent that such a scenario exists, the official unemployment rate at which inflation begins to rise varies over time. The official unemployment rate is an inaccurate measure of unused labor supply because it does not take into account workers who are employed but would be willing to work more hours.

The authors present evidence that there has been a fundamental shift in the "labor supply regime." Expansion of global markets, deregulation of key industries, weakening of labor unions, and corporate downsizing have all contributed to an environment of increased job insecurity and stagnating incomes. Such an environment provides an additional supply of labor from among incumbent workers (that is, workers who have a job and are therefore counted among the employed) to meet increased labor demand. Bluestone and Rose warn that the Federal Reserve should not grant much weight to the official unemployment rate because it fails to detect such a shift in the labor supply regime. Output can be expanded without bidding up wages by the entry of new labor force participants and by the increase in labor time of incumbent workers.

Usually, labor supply function is thought to have a positive slope (more labor is available at higher wages), but Bluestone and Rose note that there is theoretical support for a negatively sloped labor supply (more labor is available at lower wages). When the wage rate falls, workers, seeking to maintain their consumption level, may have to work more hours to compensate for the lower pay. Increased job insecurity can have a similar effect. Bluestone and Rose present evidence that both of these conditions have been growing and have contributed to the change in the labor supply regime. Using the Panel Study of Income Dynamics (PSID) as a series of cross sections, they computed the average hours of work each year from 1967 through 1989 for prime-age workers. Controlling for cyclical deviations, Bluestone and Rose ran regressions showing a trend of an increase per worker of 3.3 hours per year in work time (a total change of 66 hours more work time per year over the entire period). They also found that prime-age working couples put in 600 more hours of work per year in 1989 than they did in 1967 (by virtue of the increase in labor force participation by married women in addition to the increase in work time by each individual). However, as Exhibit 1 shows, there has been little return to most workers from this increase in hours worked.

The average working family purchased an 18.5 percent increase in real earnings with a 16.3 percent increase in hours worked for an average family wage increase of only 1.8 percent. Only the substantial increase in income for couples with a college degree kept the average increase for all couples above zero. Couples without a college degree saw their income increase by a smaller percentage than their hours worked increased, and those without a high school degree saw their earnings decline despite an increase of 11.6 percent in hours worked.

**Exhibit 1** Percentage Change in Annual Hours Worked vs. Percentage Change in Annual Real Earnings, Prime-Age Working Husband-Wife Couples, 1973--1988

| | | | Education Level[a] | | |
|---|---|---|---|---|---|
| | **All** | **Less Than High School** | **High School** | **Some College** | **B.A. or More** |
| Hours worked | 16.3 | 11.6 | 16.1 | 17.4 | 16.6 |
| Real earnings | 18.5 | -8.2 | 3.7 | 3.8 | 32.5 |
| Family wage (dollars/hour) | 1.8 | -17.7 | -10.7 | -11.5 | 13.6 |

[a] Educational level of head of household.

*Source:* Bluestone and Rose's calculations based on data from the Panel Study of Income Dynamics collected by the University of Michigan Survey Research Center.

Bluestone and Rose claim that their best evidence for a change in the labor supply regime is the increase in the trend in weekly hours worked during each of the last three recoveries, from 0.05 hours per year in the period from 1975 to 1979 to 0.16 hours per year in the period from 1992 to 1995. They also find a strong rise in job instability; 67 percent of men changed employers in no more than 1 year out of 10 in the 1970s, but only 52 percent could make that claim in the 1980s. This increased job insecurity could help explain increased voluntary overtime, moonlighting, and underemployment.

Bluestone and Rose conclude that this significant change in the labor supply regime leaves much more slack in the labor market than the official unemployment statistics appear to indicate. If because of this slack a low unemployment rate does not necessarily point to inflationary pressure, the Fed might be able to relax short-term interest rates to increase growth. Increased growth could reward "overworked Americans" with rising wages without endangering price stability.

## The Effects of Immigrants on African-American Earnings: A Jobs-Level Analysis of the New York City Labor Market, 1979--1989

David R. Howell and Elizabeth J. Mueller
Working Paper No. 210, November 1997

The improvement in the relative economic status of African-American workers in the 1960s and 1970s was reversed in the 1980s. During that decade immigration to the United States reached its highest level since the early part of this century, and many immigrants entered lesser-skilled labor markets, where most African-American labor is concentrated. Yet, in what George Borjas terms an "unresolved puzzle," most researchers have been unable to find any significant negative wage effects caused by immigration.[1] Research Associate David R. Howell and Elizabeth J. Mueller, both of the Robert J. Milano Graduate School of Management and Urban Policy of the New School for Social Research, point out that most of this research has used across-metropolitan tests despite the fact that immigrants tend to be concentrated in only a few metropolitan areas. Howell and Mueller attempt to solve the puzzle of the relationship between immigration and wages by focusing on specific jobs in specific metropolitan areas in which immigrants are concentrated.

Howell and Mueller aggregate individual-level census data for the New York metropolitan area into detailed occupation-industry cells for 1980 and 1990, identifying native-born black (NBB) job niches. This method focuses attention on particular areas of the labor market where effects are likely to occur. The authors define an ethnic job niche as an occupation-industry cell in which a particular group's share of employment is 150 percent of that group's share of the citywide employed population. In New York this means a share of employment of 18 percent or more for NBB men and 24 percent or more for NBB women. This definition produced 12 job niches for NBB males and 12 job niches for NBB females.

Howell and Mueller found that the number of immigrant workers increased in nearly all NBB male job niches and nearly all NBB female job niches in the 1980s. The mean share of foreign-born workers in NBB female job niches increased from 16.3 percent in 1980 to 31.3 percent in 1990; foreign-born workers increased their share in NBB male job niches from 20.4 percent to 36.9 percent during the same period. In most job niches the increase in the share of immigrant workers did not correspond with a decrease in the share of NBB workers, but with a decrease in the share of white workers (who moved out of the metropolitan area or into other job cells).

Howell and Mueller tested the effects of immigration on NBB earnings using jobs-level regressions for 1979 and for the change in earnings from 1979 to 1989. Using all jobs (occupation-industry cells) in which there were at least 5 NBB females or 5 NBB males produced a sample of 253 male and 240 female jobs. First, they tested for the effects of the share of immigrants in total employment on NBB earnings. Second, they tested the effect of the increase in immigration by comparing the coefficient for the 1979 sample to the coefficient for the 1989 sample. Third, they regressed the change in NBB earnings on the change in immigrant share of employment in job categories.

In the first test, an increase in the share of recent immigrants in total male employment had a strongly negative effect: a 10 percentage point increase in immigrant share was associated with a reduction in NBB male earnings of 4 to 5 percent. The results for NBB women were far weaker. In the second test, the comparison of the 1979 and 1989 samples showed strong negative effects of recent immigrants for NBB males but not for females. In the third test, an increasing share of recent immigrant workers in a job category was strongly associated with a decline in the increase in earnings of both male and female native-born blacks; the regression showed that a 10 percentage point increase in the immigrant share reduced the increase in earnings by approximately 15 percent.

Howell and Mueller's results contradict earlier research, which, for the most part, failed to find substantial earnings effects of immigration. Further research needs to be done to confirm these results, but Howell and Mueller suggest that part of the puzzle may be solved by paying more attention to the wage effects across gender and ethnicity at the job level in the areas where immigrants are concentrated.

**Note**

1. George J. Borjas, "The Economics of Immigration," *Journal of Economic Literature* 32 (December 1994): 1667-1717.

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## Income Distribution, Macroeconomic Analysis, and Barriers to Full Employment

Malcolm Sawyer
Working Paper No. 211, November 1997

The distribution of income is conspicuous by its absence from most mainstream macroeconomic analysis. Visiting Scholar Malcolm Sawyer, of the University of Leeds, makes an effort to remedy this situation by discussing three aspects of the relationship between macroeconomics and the distribution of income: the effect of conflicts over the distribution of income on the NAIRU (nonaccelerating inflation rate of unemployment), the effect of the distribution of income on aggregate demand, and the effect of monetary policy on the distribution of income.

If there is a rate of unemployment below which the struggle over income shares leads to rising inflation, the manner in which that rate is determined has immense significance for economic policy. There are different versions of the NAIRU, but in most it is a unique, supply-side-determined equilibrium level of unemployment that is a strong attractor for the actual rate of unemployment (that is, unemployment tends not to be above the NAIRU for very long) and is unaffected by aggregate demand or the inflation rate. Monetary policy is expected to be distribution-neutral because anticipated inflation is not supposed to affect relative prices.

According to Sawyer, the concept known as the NAIRU is better understood as the CISRU, or constant income share rate of unemployment, which is not a supply-side phenomenon and is not a strong attractor. The CISRU should be viewed as a constraint on full employment arising from conflict over the distribution of income. At the CISRU the difference between the increase in wages and the increase in prices just equals the increase in productivity so that the share of wages and the share of profits in national income are constant. Lower rates of unemployment create pressure for both wages and profits to rise. The CISRU is not derived from the summation of individual choices, but from the requirement that income shares be brought into some consistency. This helps explain why estimates of the NAIRU tend to vary in line with actual unemployment. Since the distribution of income is relatively stable, any estimate of a rate of unemployment that is consistent with a constant share of profits will be fairly close to actual unemployment. The CISRU is not the result of imperfections in the labor market but of a struggle over income shares. Therefore, policy for changing the NAIRU or CISRU should focus on the mechanism by which wages and prices are determined.

From a Keynesian perspective, the distribution of income could affect the level of aggregate demand because the propensity to consume out of wages is substantially higher than the propensity to consume or invest out of profits. According to Sawyer, this may cause aggregate demand to be inadequate to support full employment. If firms then adjust capacity to the level thought desirable at the lower level of demand, there may not be sufficient capital stock to employ the labor force even at full capacity utilization. As evidence for this Sawyer points to the recovery of profits and capacity utilization rates since the 1970s, accompanied by slower growth, lower investment, and higher unemployment than previously.

Sawyer cites research that throws doubt on the assumption that monetary policy is distribution-neutral. The burden of monetary contractions falls disproportionately on low-income workers, while the benefits accrue to creditors and bond market investors.1 Monetary policy has been instrumental in increasing the inequality of income, at least since the late 1970s.2 Sawyer concludes that monetary policy should not be thought of as a technical matter but as a matter with significant distributional impact. The NAIRU or CISRU should be viewed as a possible distributional constraint with the implication that mechanisms to resolve distributional conflicts without resort to the weapon of unemployment are required if full employment is to be achieved.

**Notes**

1. W. Thorbecke, "Disinflationary Monetary Policy and the Distribution of Income," Working Paper no. 185, The Jerome Levy Economics Institute, 1997.
2. C. Niggle, "Monetary Policy and Changes in Income Distribution," Journal of Economic Issues 23 (1989): 809--822.

# Seminar:

**The Mixing of Peoples: Intermarriage and the Making of Americans' History, Prospects, Policy**
Joel Perlmann

Senior Scholar Joel Perlmann lectured on proposed changes to the way the Census Bureau counts people of mixed racial ancestry. Currently, the census question on race asks respondents to choose only one of the following: white, black, Asian/Pacific Islander, Native American, or "other." People of mixed racial ancestry are forced to choose one origin over others or put themselves in the catch-all "other" category. According to Perlmann, this method is becoming increasingly inadequate because it does not recognize the growing reality of interracial marriage.

Perlmann suggests that the Census Bureau allow respondents to choose more than one origin. Responses should then be counted using an "all-inclusive" approach in which an individual can be counted as a member of more than one group. This is not without precedent; it is the method the bureau uses to count ethnic origins. Census figures on ethnicity reflect the reality of ethnic intermarriage, but the statistics on racial groups do not reflect racial intermarriage. For example, if the current system for counting race were applied to ethnic origins, only 23 percent of the descendants of Italian immigrants would be counted as "Italian-Americans" by the third generation.

One problem with changing the method of counting interracials is its effect on civil rights legislation, which currently requires legal statuses with regard to minority group membership that are "complete and nonoverlapping." Allowing people to choose more than one origin will create overlapping categories and Congress will have to decide who qualifies for civil rights protection when fewer people fit neatly into a simple racial category.

Census projections about the future racial makeup of the United States are also biased by current unrealistic assumptions about racial intermarriage. The projections assume that all mixed-race people will marry only into their mother's race and that there will be no future racial intermarriage. The number of people with some degree of mixed racial origin is increasing faster and is more widespread than the Census Bureau estimates.

Perlmann concluded on an optimistic note that as racial lines become less distinct, the significance of race will decrease, just as once powerful ethnic antipathies in the United States weakened as ethnic lines blurred.

**The Second Generation Then and Now:**
**Education and Early Job Market Experiences**

On October 23--25, 1997, the Levy Institute hosted a symposium on immigration and the second generation, organized by Joel Perlmann. In Session 1, A Way In: Past and Future, two papers were presented: "Rethinking Assimilation Theory for a New Era of Immigration," by **Richard D. Alba**, professor of sociology and public policy, State University of New York at Albany, and **Victor Nee,** Center for Advanced Study in the Behavioral Sciences, Cornell University; and "Second Generation Decline: Children of Immigrants, Past and Present--A

Reconsideration," by **Joel Perlmann,** senior scholar, Levy Institute, and **Roger Waldinger,** research associate, Levy Institute, and professor of sociology and director of the Lewis Center for Regional Studies, University of California at Los Angeles. Discussants were **Gary Gerstle,** Department of History, Catholic University of America, and **Rubén G. Rumbaut,** professor of sociology, Michigan State University.

Papers presented in Session 2, Understanding Youth Orientations, were "Exploring and Explaining the Variability: The School Performance of Today's Immigrant Students," by **Margaret Gibson,** associate professor of education and anthropology, University of California at Santa Cruz; "Achievement and Ambition among Children of Immigrants in Southern California," by **Rubén G. Rumbaut**; and "The Cultural Psychology of the Second Generation," by **Carola Suárez-Orozco**, lecturer in human development and psychology, Harvard University, and **Marcelo M. Suárez-Orozco,** professor of human development and psychology, professor of learning and teaching, Harvard University. Discussants were Josh **DeWind,** director, International Migration Program, Social Science Research Council, and **Philip Kasinitz,** associate professor of sociology, Hunter College and Graduate Center of City University of New York.

Three papers were presented in Session 3, Language, School, and Work: "English First or English Only? Bilingualism and the New Second Generation," by **Alejandro Portes,** professor of sociology and public affairs, Princeton University, and **Lingxin Hao,** Johns Hopkins University; "West-Indian Youth Reaction to American Race Relations: Implications for School and Work," **Mary C. Waters,** professor of sociology, Harvard University; and "The School to Work Transition of Second Generation Immigrants in Metropolitan New York: Some Preliminary Findings," by **Philip Kasinitz, John Mollenkopf,** professor of political science and sociology, Graduate Center of the City University of New York, **Mary C. Waters,** and **Nancy Lopez** and **Dae Young Kim,** both of the Graduate Center of the City University of New York. Nancy Foner, professor of anthropology, State University of New York at Purchase, was a discussant.

In Session 4, Education and Work in the 1990 Census
and Related Sources, three papers were presented: "Education's Hispanic Challenge," by **George Vernez,** Rand; "Educational and Sociodemographic Incorporation among Hispanic Immigrants to the United States," by **Frank D. Bean,** Ashbel Smith Professor of Sociology and Public Affairs and director of the Population Research Center, University of Texas, Austin; and "Some Early Indicators of Education and Early Career in the 1990 Census: Generations 1, 1.5, and 2," by **Joel Perlmann** and **Roger Waldinger.** Commenting were **Joseph P. Ferrie,** associate professor of economics, Northwestern University, and **Suzanne Model,** associate professor of sociology, University of Massachusetts Amherst.

The paper presented in Session 5, Historical Comparisons/ General Reflections, was "Comments for `The Second Generation Conference' at The Jerome Levy Economics Institute," by **Thomas Archdeacon,** professor of history, University of Wisconsin.
Some of the papers will be issued as Levy Institute working papers and will be summarized in future issues of this publication. A portion of the discussion is summarized here.

Gary Gerstle opened the discussion with a "friendly critique" of works discussing second-generation decline by and Victor Nee and by Joel Perlmann and Roger Waldinger. Gerstle asked what evidence there is that the children of immigrants are not keeping up with their parents; he has found that immigrants in the late nineteenth and early twentieth centuries did not assimilate as quickly as people now think they did, and "segmented assimilation," the movement of some immigrants into the middle class while others assimilate into the underclass, is nothing new. Immigration will certainly "brown" America, but since racial categories are fluid and socially constructed, that process could take different paths. Gerstle sees as an optimistic possibility that, as mixed race people become the majority, the significance of race will decline. A more pessimistic view is that new immigrant groups will move ahead by forging an identity as "not-black."

Much of the discussion followed from Perlmann and Waldinger's contention that, with the exception of Mexican immigrants and their descendants, most immigrant groups on average are educationally and economically nearly indistinguishable from the native born. Alba and Alejandro Portes both warned that a distinction between Mexicans and all other immigrant groups could be an oversimplification. Alba noted that 60 percent of the descendants of Mexican immigrants are monolingual English speakers by the third generation. Portes commented that although many Mexican immigrants are not economically successful, other immigrant groups are having similar difficulties; Mexicans may be singled out because the group is so much larger than other groups. Eventually, symposium participants seemed to settle into a consensus that the distinction could be drawn, but should not be overinterpreted. Calling attention to the distinction is designed to show that most immigrant groups are doing better than might be thought by looking at aggregate statistics. It is in no way meant to imply that the "real issue" is the difference between Mexican Americans and other immigrant groups. Because of the proximity of Mexico to the United States and the large number of illegal immigrants from Mexico, the Mexican immigrant group is likely to consist of more low-income and low-skill immigrants than other immigrant groups. Mexican Americans also face American cultural stigmatization similar to that faced by African Americans.

In a discussion of assimilation, Gerstle mentioned that the differences between assimilation, Americanization, and economic success are not well understood. Waldinger added that assimilation may not be the most useful concept, but it is one that must be addressed because it is so imbedded in American history and the American perception of immigration. He is more concerned with "membership": What does it take for immigrant groups to become fully accepted as members of American society?

Many participants expressed a concern that was quite the opposite of the common concern that immigrants are not assimilating. Participants agree that immigrant groups are assimilating at a rate similar to immigrants of earlier periods in American history, but worry that immigrants are losing too much of their ethnic heritage. As Nancy Foner commented, bilingualism is an economic asset, and bilingual descendants of immigrants consistently outperform monolingual English-speaking descendants economically and educationally.

Some participants spoke on educational attainment and membership in the underclass. There is evidence of segmented assimilation and second-generation decline in the educational attainment of second and third generations. However, the difference in educational attainment between generations is less than the difference between ethnic groups. Opposition culture is strong and widespread in the United States and some children of immigrants adopt its values. As Philip Kasinitz put it, "Even American opposition culture is hegemonic." Thomas Archdeacon and others returned to the question of race, noting that it is unfortunate that African Americans have become identified with the underclass and that one could measure the success of immigrant groups by how quickly they surpass African Americans in social and economic status.

## Scholars

Research Associates **William J. Baumol** and **Edward N. Wolff** are conducting a research project entitled "Protracted Frictional Unemployment as a Heavy Cost of Technical Progress." They argue that there is more substance to the public's fears that new production techniques can threaten jobs than is acknowledged by either neoclassical or Keynesian economists. They note that neoclassical economists, who believe that the market tends automatically to bring the economy back to full employment or at least to a natural rate of unemployment, seem inclined to believe that this process wipes out any joblessness created by technological change with a modest delay. The Keynesian economists, who believe that the level of employment can be adjusted by macroeconomic policy, are inclined to believe that policy is capable of eliminating the joblessness engendered by labor-saving innovation.

Baumol and Wolff suggest that the rapid pace of technological change can have two profound employment effects. First, it can materially increase frictional unemployment. Second, it can affect some classes of workers more than others because of the sunk-cost attributes of retraining workers to enable them to use the constantly emerging novel techniques. The least-educated workers; older, former jobholders; and women, particularly of childbearing age, are likely to be the groups most affected by the pace of change, suffering declining relative wages or protracted and possibly lifetime unemployment.

Weighing the evidence of the human cost of protracted unemployment, Baumol and Wolff note that it is simply not true that unemployment of one person for five years is somehow equivalent to unemployment of ten persons for six months each. In their research they are exploring the costs of joblessness beyond the loss of income, considering divorce, mental illness, suicide, violence in the home, and other social costs. The research will conclude with an appropriate public policy response. Baumol, who received a Ph.D. from the University of London, and Wolff, who received a Ph.D. from Yale University, are both professors of economics at New York

University.

Visiting Scholar **Mathew Forstater** is engaged in projects on employment and federal budget policy. He is using a historical, interdisciplinary approach to examine the potential role of full employment policies in the face of deficit reduction and continual technological change. Forstater is an assistant professor at Gettysburg College. He received a Ph.D. in economics from the New School for Social Research.

Research Associates **Robert Haveman** and **Barbara Wolfe** are conducting research that addresses the relationships among economic activity, underemployment, and human capital in the United States from 1973 to 1990. They endeavor to (1) document the growth of human capital in the U.S. economy since the early 1970s, (2) estimate inequality in the distribution of human capital within the working-age population and document any changes in inequality, (3) explore patterns of utilization of human capital within the working-age population (that is, changes in the overall utilization rate of human capital during the past 20 years) and the contribution of shifting patterns of human capital utilization among age, gender, and ethnic groups to changes in the overall capacity utilization rate, (4) identify factors that have determined measured changes in the growth, distribution, and utilization of human capital, and (5) explore the duration and determinants of underutilization over time.

If the objective of policy is to increase the utilization of human capital and, therefore, economic activity so that every race, gender, education, and age group in the working-age population is working close to its capacity, then it is important to understand the aggregate level of underutilization and its distribution within the working-age population. Does the greatest potential lie in reducing economic inactivity among younger or older workers, among males or females, or among less-educated or more-educated workers? The answers to these questions will indicate whether policies targeted at youths (such as Job Corps and youth employment policies), older workers (changes in Social Security and disability benefits), or young women (changes in welfare policy) are likely to be more effective in increasing economic activity. Haveman is the John Bascom Professor of Economics and Public Affairs at the University of Wisconsin, Madison; he received a Ph.D. from Vanderbilt University. Wolfe is a professor of economics, preventive medicine, and public affairs at the University of Wisconsin, Madison; she received a Ph.D. from the University of Pennsylvania.

Research Associate **David R. Howell** focuses on the implications of changes in industry characteristics, especially the adoption of information technologies, for employment, skill requirements, and earnings. Specifically, he is examining the effects of recent employment restructuring on young workers by race and gender. His results thus far imply a strong link between changes in the rates of labor market discouragement and changes in job opportunities, job quality, and educational requirements. Howell is an associate professor of economics at the Robert J. Milano Graduate School of Management and Urban Policy of the New School for Social Research. He received a Ph.D. in economics from the New School. He is the author of Public Policy Brief No. 29, *Institutional Failure and the American Worker*.

Research Associate **William H. Lazonick** is conducting research that encompasses the issues of global competition, corporate governance, employment, and the distribution of income. Much of the research focuses on the skill base hypothesis, which posits that human resource investment can take one of two forms: a broad and deep skill base, in which skilled work is conducted by many people at many different levels of the organizational hierarchy, or a narrow and concentrated skill base, in which skilled work is conducted by a small and elite portion of an organization's workforce. Lazonick will explore how a difference in skill bases has affected industrial competition between the United States and Japan and whether such skill-based competition has affected U.S. employment. He will also examine statistics on U.S. income distribution from the perspective of the skill base hypothesis to find (1) the degree of international competition in specific industries and (2) the governance of strategy and learning in a successful U.S. enterprise group. Lazonick is university professor and co-director of the Center for Industrial Competitiveness at the University of Massachusetts Lowell and a visiting scholar at the Euro-Asia Centre of INSEAD (the European Institute of Business Administration). He received a Ph.D. in economics from Harvard University.

Research currently conducted by Resident Scholar **Oren M. Levin-Waldman** focuses on restructuring the welfare and unemployment insurance systems to achieve greater efficiency, equity, and effectiveness in the delivery of services and on developing a methodology for analyzing public policy that relies on the application of political philosophy as well as cost-benefit analysis. Recently, he has been examining the effects of a change in the minimum wage, worker displacement due to plant closures, welfare reform and the potential for workforce development, and political realignment in the electorate. Levin-Waldman received a Ph.D. in political science from Temple University. He is the author of Public Policy Brief No. 21, *The Consolidated Assistance Program*; No. 26, *Making Unemployment Insurance Work*; and No. 31, *A New Path from Welfare to Work*. He also is the author of *Reconceiving Liberalism: Dilemmas of Contemporary Liberal Public Policy* (University of Pittsburgh Press).

Executive Director **Dimitri B. Papadimitriou**, along with Senior Scholar L. Randall Wray, is currently conducting research to assess the effect of demographic shifts--specifically, the aging of the population--on the labor market in light of the current slow growth in labor force participation rates and based on different ranges of productivity growth. Papadimitriou and Wray will then evaluate the need to revise public policies concerning the retirement age, the Social Security program, and macroeconomic employment policies. They also will continue their work in the program on restructuring in the financial services sector on the appropriateness of using existing price indexes as targets for monetary policy and will apply their findings to OECD countries. In addition to his duties as executive director, Papadimitriou is executive vice president of Bard College and Jerome Levy Professor of Economics at Bard. He received a Ph.D. in economics from the New School for Social Research. He is the author of several Public Policy Briefs: with Hyman P. Minsky, Ronnie J. Phillips, and L. Randall Wray, No. 3, *Community Development Banking*; with Phillips and Wray, No. 6, *A Path to Community Development*, and No. 12, *An Alternative in Small Business Finance*; with Wray, No. 15, *Monetary Policy Uncovered*, and No. 27, *Targeting Inflation*.

Senior Scholar **Joel Perlmann** is guiding a research initiative entitled "Ethnicity and Economy in America--Past and Present." The initiative focuses on the processes by which immigrants and their descendants are assimilated into U.S. economic life. It is hoped that this work will shed light on current policy issues related to immigration, such as international competitiveness, the labor market, income distribution, and poverty.

Perlmann is engaged in three research projects to further this initiative. The first, "The Jews Circa 1900: Social Structure in Europe and America," focuses on social characteristics that help explain the rapid socioeconomic rise of eastern European Jewish immigrants who entered the American economy at the turn of the century. Perlmann is using census data that were previously unavailable or not machine readable to examine social and economic characteristics of eastern European Jewish populations who emigrated to the United States and those who remained in Europe.

Perlmann's second project, "Assimilation and the Third Generation," explores the assimilation of immigrants into the socioeconomic mainstream of the United States and the social and economic experiences of their native-born children. Special attention is paid to a few large groups whose absorption seemed especially slow and painful during the first and second generations: Irish immigrants who arrived in the mid nineteenth century, Italians and Poles who immigrated between 1880 and 1920, Mexicans who arrived throughout much of this century, and southern-born blacks who migrated to the North. Perlmann uses census data in new ways in order to identify and trace second- and third-generation Americans.

Perlmann's third project, "The New Immigration's Second Generation," conducted with Research Associate **Roger Waldinger**, UCLA professor of sociology, reviews literature that deals with the economic progress and difficulties faced by children of immigrants today and compares their experiences with those of children of turn-of-the-century immigrants.

Perlmann, who also holds the post of Levy Institute Research Professor of History at Bard College, received a Ph.D. in history and sociology from Harvard University.

Senior Scholar **L. Randall Wray** is currently working on several projects in the areas of aging, employment, and monetary policy. He is studying policies to promote full employment focusing on Hyman Minsky's "employer of last resort" proposal and, with Executive Director Dimitri B. Papadimitriou, is conducting research to assess the effect of demographic shifts--specifically, the aging of the population--on the labor market in light of the current slow growth in labor force participation rates and based on different ranges of productivity growth. Papadimitriou and Wray will then evaluate the need to revise public policies concerning the retirement age, the Social Security program, and macroeconomic employment policies. They also will continue their work in the program on restructuring in the financial services sector on the appropriateness of using existing price indexes as targets for monetary policy and will apply their findings to OECD countries. Wray has been an associate professor at the University of Denver and a Fulbright Research Scholar at the University of Bologna. He received a Ph.D. from Washington University in St. Louis. He is the author of several Public Policy Briefs: with Hyman P. Minsky, Dimitri B. Papadimitriou, and Ronnie J. Phillips, No. 3, *Community Development Banking*; with Papadimitriou and Phillips, No. 6, *A Path to Community Development*, and No. 12, *An Alternative in Small Business Finance*; with Papadimitriou, No. 15, *Monetary Policy Uncovered*, and No. 27, *Targeting Inflation*.

# Program: Restructuring in the Financial Services Sector

## Summary of New Working Paper

**Cumulative Regional Decline, Institutional Inadequacy, and the "Democratic Deficit": Is European Monetary Union Economically and Politically Sustainable?**
Andrew Paulson
Working Paper No. 209, October 1997

European monetary union (EMU) now seems increasingly likely to progress as planned with a membership of 8 to 10 countries in 1999. There has not been great enthusiasm among European citizens for integration, but there has not been great hostility either. Since there has been little political polarization on the issue, EMU has never been properly addressed in the public policy arena. Current discussions ignore the broad implications of monetary union and focus on the technical details: interpretation of the convergence criteria, speculation on which nations will be included, the redenomination of national debts, and the operational structure of a European central bank. Cambridge University Visiting Scholar Andrew Paulson examines the case for EMU, asserting that a series of questions must be addressed before a conclusion can be made in favor of monetary union. First, is greater political, social, and economic union good for Europe? Second, is EMU the logical next step toward greater union? Third, is the Maastricht treaty the best method to move toward EMU?

Many arguments for EMU are based on the gains that would accrue from a reduction of transaction costs. Paulson points out, however, that these gains would be trivial, at best amounting to one-half of one percent of community GDP. Other arguments are based on expected long-term dynamic gains from the elimination of uncertainty about future exchange rate movements and the expected gains from "stability," which apparently means only price stability. The EMU's presumed increased price stability apparently rests on the belief that somehow a European central bank will be better able to control inflation than member states' central banks. Finding the economic case for EMU to be insignificant, Paulson supposes that the true motivation for monetary union is not economic but political.

Various member states have different political motives for wanting a strong union, such as to solidify democracy in the former dictatorships, to gain international legitimacy in Germany, and to regain political prominence in the former colonial powers. Paulson points out, however, that the will among European citizens to move toward political integration simply does not exist at this time. He asserts that there has been no official discussion of the political union and no notion of what it entails. Yet, private discussion invariably reveals that the motive for monetary union is to create a vehicle that will somehow lead to greater political union.

According to Paulson, even if long-term political integration is desirable, monetary union in general and the Maastricht treaty in particular are not the next logical steps toward political integration and could lead in the opposite direction. The Maastricht treaty exposes the European Union (EU) to risks it may not have the institutional structure to handle because the treaty obliges member states to give up both their monetary authority and a considerable amount of fiscal authority, but creates only a centralized monetary authority. There is no new authority to assume the fiscal powers the treaty obliges member states to relinquish.

As an example of what could go wrong, Paulson considers a situation in which different regions of the community experience different economic conditions. As separate nations, EU members would be free to pursue the appropriate fiscal and monetary policy. If the EU were a single nation, three possibilities would exist to equalize economic conditions across regions--labor mobility, wage changes, and a progressive tax and transfer system--all of which are absent from the European monetary union. Cultural and linguistic barriers prevent labor from migrating easily in response to economic conditions; wages in Europe are traditionally inflexible; and there is no international tax and transfer system to redistribute income from richer to poorer regions (and there is no significant support for introducing one). Thus, unifying the monetary system without creating the appropriate institutional structure will make Europe more vulnerable to regional decline, which could lead to disunity and interfere with progress toward European cooperation.

According to Paulson, the Maastricht treaty has another and a much more basic flaw: it is undemocratic. It leaves member states without any democratic process by which the treaty's criteria or any other restrictions can be amended. Recently, the French people booted out a government that set austere economic measures in place to ensure compliance with Maastricht's debt criteria, but they could not vote out Maastricht's requirements. Paulson concludes that the Maastricht EMU is not the best path toward greater European union. He contends it would be better to begin by extending the European budget and increasing labor mobility, so that a currency union will follow as a result of greater fiscal and political union rather than being imposed as a wishful attempt to spark political union.

### Scholars

Cambridge University Visiting Scholar **Stephanie Bell** is applying Hyman P. Minsky's accounting procedures to an analysis of bank reserve accounting, the Federal Reserve Board, and monetary policy formation. She is also studying the relationship between government deficit spending and bank reserves and the implications of this relationship for monetary policy. She received a B.A. in economics and a B.S. in business finance from California State University at Sacramento and an M.Phil. from Cambridge University.

Research Associate **Willem Thorbecke** is investigating the effects of monetary policy on various sectors and segments of the economy. Employing impulse response functions and social accounting matrices, Thorbecke will trace the effects of monetary policy on different socioeconomic groups during specific time periods (such as the 1979--1982 Volcker deflation and the 1994 preemptive strike against inflation). By examining whether cyclical downturns disproportionately affect different types of workers employed by firms of various sizes, Thorbecke will shed light on how monetary policy affects financial markets and the economy and on how the burden of contractionary policy is distributed among members of society. Thorbecke is an associate professor of economics at George Mason University. He received a Ph.D. in economics from the University of California at Berkeley.

## Program: International Trade and Competitiveness

### Summary of New Working Paper

**Are Good Jobs Flying Away? U.S. Aircraft Engine Manufacturing and Sustainable Prosperity**
Beth Almeida
Working Paper No. 206, August 1997

Aerospace, once the "crown jewel" of U.S. manufacturing, is experiencing a structural decline characterized by a narrowing of the industry trade surplus, an increase in the foreign content of commercial aircraft and engines, a greater role for foreign companies in research and development, and a loss of "good jobs." Employment in aircraft engine manufacturing peaked in 1988 at over 141,000 employees and plummeted to just over 76,000 in 1995. Beth Almeida, of the Center for Industrial Competitiveness at the University of Massachusetts Lowell and the Department of Economics at the University of Massachusetts Amherst, examines the decline of the aircraft industry and attributes the slipping competitive advantage of the United States to the failure of American firms to extend organizational learning to the shop floor.

According to Almeida, American aerospace dominated the world market in the 1950s and 1960s because of support from the Defense Department and a regulated commercial market. In the 1970s, just as competitors were entering the market, U.S. manufacturers had to face deregulation and decreased government support. In response they chose to pursue strategies such as downsizing to drive costs down. The government-supported European manufacturer Airbus began production in 1974, and MITI began targeting resources to develop a Japanese aerospace industry. As another cost-cutting measure, U.S. manufacturers looked to foreign partners to collaborate in production and share financial risks, giving Japanese and Europeans inroads into the American market.

The strong market position of foreign manufacturers has greatly increased price competition in the industry. According to Almeida, to remain competitive, U.S. manufacturers need to invest in personnel at all levels of the production process, but they have paid only lip service to such a strategy and have continued to try to cut costs by squeezing their workforce. For example, General Electric, a major manufacturer of aircraft engines, has introduced the practice of "multiprocessing," which allows managers to assign multiple operations to any worker without any additional investment in training or input from workers. Proposals to introduce this practice have been rejected by unions in two GE plants. GE chief Jack Welch talks of quality, training, and incentive bonuses, but quality and training refer only to "quality black belts," managers who spend full-time roaming GE plants setting up quality improvement projects, and only managers are eligible for incentive bonuses. The only incentive for production workers is the fear of job loss or being reassigned to shift work. Years of downsizing have not proven to be a good long term-strategy; GE and other major U.S. manufacturers no longer have the capacity to take advantage of the recent upswing in orders.

Almeida concludes that to be truly competitive on the international market, U.S. aerospace firms will need to take steps toward investment in worker skills and collaboration between management and the shop floor.

## Scholar

Two accounting-based models form the foundation of much of Distinguished Scholar **Wynne Godley**'s research. The first model tracks the evolution of the U.S. economy using a consistent system of stocks and flows (such as income, production, and wealth). This system of information makes it possible (1) to identify significant trends and magnitudes, suggest policy responses to problems, and gauge economic outcomes and (2) to assess the economic implications of different policy regimes. Godley's findings from this model are to be published as an annual Levy Institute publication. The second model is a "closed" world model in which 12 trading blocks--of which the United States, China, Japan, and Europe are four--are represented. This model is based on a matrix in which each block's imports are described in terms of exports from the other 11 blocks. From this information and using alternative assumptions (for example, about growth rates, trade shares, and energy demands and supplies), past trends can be identified and the patterns of trade and production analyzed to reveal any structural imbalances.

With Resident Scholar **George W. McCarthy Jr.** and Gennaro Zezza, of the Financial University Degli, Godley is writing an economics textbook, tentatively titled *Stock-Flow Economics* . The book is based on a number of models, including a theoretical model as well as the U.S., U.K., and world models. Godley was a member of HM Treasury's Panel of Independent Forecasters, the so-called Six Wise Men. He is a professor emeritus of applied economics at Cambridge University and a fellow of King's College. He is the author of Public Policy Brief No. 23, *A Critical Imbalance in U.S. Trade.*

# Program: Federal Budget Policy

## Summary of New Working Paper

**On Budget Deficits and Capital Expenditure**
Malcolm Sawyer
Working Paper No. 208, October 1997

It has become accepted that the government budget should be divided between capital and current expenditure, that all capital expenditure should be debt financed, and that all current expenditure should be tax financed, regardless of the macroeconomic effect. Some have labeled this the "golden rule of public finance." Visiting Scholar Malcolm Sawyer, of the University of Leeds, criticizes the golden rule on three grounds. First, capital expenditure by the government does not yield a flow of revenue the way capital expenditure by businesses does. Second, the rule interferes with the government's use of deficit spending as a demand management policy. Third, it is not possible for the federal government budget to make a clear distinction between capital and current expenditure.

According to Sawyer, the case for a particular form of expenditure (whether capital or current) should be based on its social usefulness. The size of the deficit should depend on the debt stability condition and the need to use deficit spending to stabilize aggregate demand. But, there is no inherent link between the social usefulness of capital expenditure and the need for demand management. The golden rule says nothing about how large the deficit should be, and, in practice, it would mean that any aggregate demand stabilization policy would require the government to vary investment spending over the business cycle.

Sawyer addresses three justifications for the golden rule. First, capital expenditure is said to be a "one-off" expense (that is, a large, one-time expense), making it reasonable to smooth the cost over time. However, current expenditure, such as disaster relief, also varies over time. Although capital spending varies yearly, it does not have a one-off nature; to have capital financing follow a smooth time pattern would require borrowing to cover capital expenditure over some "base" amount.

Second, the rate of return on capital expenditure is said to justify the cost of finance. However, the social benefits of public investment do not generally yield any direct financial benefit to the government in the form of taxes. The bulk of government activity is nonmarket, so there is no direct cash flow back to the government as a result of its investments, only indirect cash flows generated through more business activity and possibly more taxes. The government is simply not analogous to a large firm. The government does not run deficits or surpluses to maximize its long-run revenue as a business would, but it must consider the impact of its behavior on the macroeconomy. The monetary returns to the government depend on the degree to which the benefits of capital expenditure are recaptured as taxes. But, since according to Sawyer, tax rates tend to be on the order of 30 percent, the cash flow rate of benefits would have to be 3 to 1 or more for the government to "profit" from capital expenditure.

Third, borrowing for consumption is said to be wrong. However, Sawyer states, the issue should be the social usefulness of a project rather than whether it is classified as current or capital expenditure. It is difficult to determine what capital expenditure is from a societal standpoint. For a business an appropriate definition is that capital expenditure is spending on a tangible asset that generates future revenue to the enterprise. A definition more appropriate to government is that capital expenditure is spending that generates a stream of future benefits, regardless of whether any of those benefits return to the government in the form of revenue and whether the spending is on tangible or intangible assets. A high portion of government capital expenditure is on intangible assets and generates benefits to individuals that do not make their way back to the government in the form of revenue and so, in that regard, the expenditure is not different from current expenditure.

According to Sawyer, the distinction between capital and current is arbitrary. For example, military hardware is considered capital expenditure although it generates no future income stream. Education is counted as current expenditure although it generates a stream of future revenue by increasing the productivity of future workers. The government could shift items between capital and current accounts. Since there is no major distinction between current and capital expenditure today, there is little incentive for shifting spending today, but the golden rule would create such incentive and would likely make it common to shift spending from one account to the other.

Sawyer concludes that all public expenditure, whether current or capital, should be judged on the same two criteria: social usefulness and macroeconomic stability effects. It is not prudent for the government to follow rules of finance that apply to individuals or businesses. The government's current and capital expenditures share the essential features that both have to be financed, yet neither gives rise to direct financial inflows. Therefore, there is little merit to a rule that only capital expenditure can be financed by borrowing.

## Scholars

While at the Levy Institute, Visiting Scholar **David A. Aschauer** is pursuing research interests in two areas of fiscal policy. The first line of research builds on his long-term investigation of the effect of federal expenditures (especially infrastructure investment) on economic growth and development. Aschauer is developing a new methodology for research in this area to provide further empirical evidence linking public capital and the performance of the national, state, and local economies. In his second line of research Aschauer is examining the desirability of a productivity budget for the federal government. He examines reasons for the use of public sector debt rather than current taxation for the financing of public expenditures that raise long-term productivity growth. Aschauer is Elmer W. Campbell Professor of Economics at Bates College. He received a Ph.D. from the University of Rochester. He is the author of "Public Capital and Economic Growth" in Public Policy Brief No. 4, *Public Infrastructure Investment: A Bridge to Productivity Growth?*

Policy Advisor **Edward V. Regan0** is actively engaged in issues of corporate finance, pension fund and institutional investment, and financing public infrastructure. Regan, who served for 14 years as comptroller of New York State, is now chairman of the Municipal Assistance Corporation (MAC) for New York City and is a member of the Levy Institute Board of Advisors. He is the author of Public Policy Brief No. 16, *Infrastructure Investment for Tomorrow* .

# Special Projects

## Summaries of New Working Papers

**Macroeconomics without Equilibrium or Disequilibrium**
Wynne Godley
Working Paper No. 205, August 1997

Distinguished Scholar Wynne Godley creates a numerical simulation model that attempts a synthesis between the monetary theory of Hicks and Kaldor, the asset allocation theory of James Tobin, and the Keynesian theory of income and output determination. Methodologically, it substitutes Walrasian rigor for the usual narrative exposition used by post-Keynesian writers, and indeed by Keynes himself, before the computer age. The meaning of the title is that the model describes neither an equilibrium where prices clear markets nor a disequilibrium where price signals do not work properly because of the rigidities, information inadequacies, etc. characteristic of, for instance, "New Keynesian" macroeconomics.

The central ideas, none of which are new taken individually, are that firms make decisions, under conditions of uncertainty, about prices and production that are based on expectations about future sales; and it is because production takes time and sales cannot reliably be predicted that firms have a systemic need for finance. Similarly, households make decisions under conditions of uncertainty about future income with regard to consumption and asset allocation. Banks carry out indispensable roles in two different contexts simultaneously. They provide the finance for which firms have a systemic need, accommodating any nonfulfillment of expectations by allowing loans to fluctuate with inventories; at the same time they mediate the asset choice of households and match any nonfulfillment of expectations there by allowing stocks of money and cash to respond flexibly. Banks can carry out all these operations, and also remain profitable, because they can determine loan and deposit rates (which feed back to households' asset allocation decisions) as long as the central bank always stands as lender of last resort.

All the events postulated in this model occur as sequences in "real" time. As Godley puts it,

> Historical time is intrinsic because the past, in the form of state variables, is inherited by each period; then a transition to a new state takes place which becomes the inheritance of the subsequent period. . . . Nothing can be known about the real world unless it is actually studied empirically, hence no greater claim is made for the model presented here than that it is an elementary schema laying out a rigorous

> space within which empirical macroeconomics can proceed. . . . The model, looked at one way, is the extreme antithesis of the Walrasian model. Yet agents' disparate plans, expectations and outcomes are all reconciled with one another in it--though obviously not by a heavenly auctioneer calling prices; the reconciliation occurs through the agency of banks when they allow loans and all kinds of money to expand and contract, without anyone even noticing, in response to the uncoordinated needs of firms and households.

As the model describes sequences in time, which are often chaotic, its properties cannot be ascertained or communicated by analytic methods. To overcome this problem, Godley has recourse to numerical simulation using a model that is Walrasian in the sense that of its 39 equations 1 is implied logically by the other 38. He takes four cases. In the simplest case he assumes a single shock to a steady state; in more complex examples he imagines multiple random shocks and shows how banks can accommodate chaotic behavior while remaining profitable and solvent. Each simulation is illustrated by several charts showing not only the response of income and output flows, but also the consequences for interest rates and the balance sheets of households, banks, and the government. And each experiment is accompanied by a narrative explanation of why the results come out as they do. One crucial finding is that once banks are allowed a realistic function in a macroeconomic model, there can be *no such thing* as an exogenous money supply, if "money" means bank money. Also, "high-powered money" cannot be controlled, except indirectly, by central banks--a fact well-known to central bankers.

Godley presents his paper as an important challenge to the mainstream approach to macroeconomics.

**Reasserting the Role of Keynesian Policies for the New Millennium**
Philip Arestis and Malcolm Sawyer
Working Paper No. 207, August 1997

Philip Arestis, of the University of East London, and Visiting Scholar Malcolm Sawyer, of the University of Leeds, assert the need for revived and revised Keynesian policies to secure full employment. They do not support "fine tuning," but argue for a medium-term approach that includes both demand-side and supply-side strategies. Their approach is Keynesian in two ways. First, they contend that a laissez-faire market economy does not ensure full employment. Second, they believe that a more equal distribution of market power, income, and wealth is both a desirable goal in itself and a vehicle for increasing prosperity. They discuss the constraints that prevent full employment and policies to deal with them.

According to Arestis and Sawyer, there are six constraints to full employment. (1) The aggregate demand constraint exists because neither flexible prices nor flexible interest rates are enough to ensure that planned saving equals planned investment; hence, aggregate demand may not be enough to accommodate aggregate supply. (2) The funding of budget deficits is a constraint because it limits the ability of governments to run a deficit sufficient to underpin full employment. Deficits are unsustainable if the interest rate exceeds the growth rate of the economy, but even if deficits are economically sustainable, they may be politically unsustainable or may cause an adverse reaction in financial markets. (3) The inflation constraint exists because moving toward or maintaining full employment may generate inflationary pressure. However, Arestis and Sawyer caution that the nonaccelerating inflation rate of unemployment (NAIRU) is a barrier to full employment only because policymakers mistakenly *believe* it exists and act as if full employment were unachievable. They contend that the concept of a NAIRU relies on incomplete theories and estimates of the NAIRU are unstable. They do concede that various claims made on national income at full employment may be incompatible and the resulting conflict may lead to inflation. (4) The balance of trade constraint limits a nation's ability to borrow. Balance of trade will be achieved by a laissez-faire regime as long as the growth of the domestic economy exceeds the rate of interest on foreign borrowing. Otherwise, a debt-trap will occur. (5) The high productivity constraint involves the problem of ensuring worker effort with full employment. The fear of unemployment motivates employees to work efficiently. A sustained high level of employment would require the development of other mechanisms to elicit a high level of worker productivity. (6) Lack of capacity is a constraint because the size of the workforce and the size of the capital stock are determined by different variables and need not be equal. If firms adjust plant size to the level of demand, after a sustained period of low demand, the capital capacity may be insufficient to employ the existing labor force even at high levels of demand.

Arestis and Sawyer's demand-side strategies involve both fiscal and monetary policy. Stimulating the economy by running a budget deficit is preferable to reducing saving or the trade deficit, but fiscal policy decisions must take into account the reactions of financial markets, which may frustrate the government's ability to run a deficit. Monetary policy should ensure the stability of the financial system and keep interest rates as low as possible to relieve the constraints to using a budget deficit as a fiscal stimulus. The authors warn, however, that creation of money can finance real expansion or it can cause increased prices. Deficits can be used to improve international competitiveness or to achieve unsustainable levels of consumption. They see flexible exchange rates as a source of instability and prefer an international monetary system with adjustable pegged exchange rates with arrangements for deficit countries to overcome their position without deflationary biases. This strategy, they say, will serve the requirements of trade rather than encourage financial flows.

Arestis and Sawyer advocate three supply-side strategies. First, they advocate some degree of centralization of pay setting to determine a consensus on the distribution of income in order to prevent rising wages and prices from causing an inflationary spiral. Second, they contend that an industrial strategy must be formed to provide a coherent framework for both private and government decision making. This, they assert, will lead to greater product development, enhanced productivity, and more balanced trade. Third, they argue that, to motivate workers to behave productively, worker participation in firm decision making is needed rather than the threat of unemployment.

Arestis and Sawyer endorse the view that the choice of economic strategy can be characterized as a choice between "high road" and "low road" management schemes. The low road scheme results in an economy based on competition, rivalry, and negative work incentives enforced through unemployment. The high road scheme results in an economy based on high investment and technological change with substantial cooperation between workers, employers, and governments, both within and between nations. The authors conclude that full employment and stable prices can be achieved with the involvement of a competent government, a consensus on the distribution of income, and a clear understanding of the constraints that must be overcome to achieve full employment and growth.

**An Efficiency Argument for the Guaranteed Income**
Karl P. Widerquist and Michael A. Lewis
Working Paper No. 212, November 1997

The poverty rate has been stagnant or increasing in the United States in the last 25 years, despite continued economic growth. Welfare reform appears to represent a retreat from the U.S. government's 60-year-old commitment to fight poverty. However, much of the language of welfare reform advocates has been based on the idea that the current welfare system is not cost effective or that it has become a trap and itself part of the problem. The belief that workers should not live in poverty remains strong, and the idea, expressed by Bob Dole in the 1996 presidential debates, that "This is America; nobody's going to starve" is not controversial, even in partisan debates. Research Associate Karl P. Widerquist and Michael A. Lewis, of the School of Social Work of the State University of New York at Stony Brook, examine different reform proposals and conclude that if the goal of policy is to reduce or eliminate poverty, the most cost-effective method is the guaranteed income.

Widerquist and Lewis examine how different policies work against different theoretical causes of poverty: physical inability to work, single-parenthood, low human capital, inadequate demand for labor (from both a Keynesian and a neoclassical perspective), and lack of work ethic. The policies discussed include policies to promote economic growth and full employment, Workfare, the minimum wage, separating the "deserving" and "undeserving" poor, public employment, and the guaranteed income.

Widerquist and Lewis claim that the guaranteed income is the most comprehensive and efficient poverty policy because it works whatever the cause of poverty. Its structure provides significant work incentives. The guaranteed income would provide a minimum amount below which no citizen's income would be allowed to fall. The completely destitute would be able to live on the minimum. Those with a low private income after taxes would receive a reduced subsidy so that they would be net beneficiaries and would be significantly better off than those without private income. Those with a higher private income would be net taxpayers, but would be significantly better off that those with less income. This structure, while providing income, gives workers the incentive and the flexibility to take advantage of job opportunities if they are available, unlike programs that make workers give up all of their benefits if they take a private sector job.

Those who are physically unable to work would have an income on which they could live. Those who are partially disabled and single parents could rely on the same minimum, but they would have an incentive to earn private income if they could. The guaranteed minimum not only gives a partial subsidy to low-wage workers, but allows them some flexibility to take advantage of education and training. If, as Keynesian theory supposes, low demand causes unemployment, the guaranteed income acts as an automatic stabilizer and protects workers' income while they are unemployed. If, as neoclassical theory supposes, low demand for labor causes low wages and high voluntary unemployment, the minimum income offers an effective wage subsidy and an improved bargaining position for workers. If lack of work ethic is the problem, recipients will benefit from the improved incentive structure, while still being kept from complete destitution and homelessness.

According to Widerquist and Lewis, the most important effect of the guaranteed income is its effect on low-wage workers. Ten percent of Americans who work full-time year-round live in poverty despite existing policies. Most welfare reform proposals focus on moving recipients into the workforce, with no discussion of whether they will earn a living wage or only join the working poor. If the latter occurs, welfare reform will depress wages and increase poverty among the working poor. According to Widerquist and Lewis, the guaranteed income will give low-wage workers the market power to command higher wages and the incentive to take jobs with higher wages.

## Selection from New Book

**Using Figures to Guide Macroeconomic Policy**
Wynne Godley

Distinguished Scholar Wynne Godley discusses the use of modeling in guiding macroeconomic policy in his chapter in the book *Applied Economics and Public Policy*, edited by Iain Begg and S. G. B. Hentry (Cambridge University Press, forthcoming). Godley makes some suggestions about how to reach well-grounded conclusions about macroeconomic policy and how such work can be rationalized, codified, taught, and evaluated.

Although Godley always uses a formal model of the economy to carry out strategic policy evaluations, he believes strongly that the idea of an econometric model that in any real sense thinks for the analyst is anomalous; the purpose of a model is rather to enlarge the capacity of the mind to encompass a more complex system of interrelationships than would otherwise be possible. The main part of any forecasting exercise should consist of a careful analysis of the recent past that tries, in particular, to identify which features of the present are the same as and which are different from earlier periods. Thus pattern recognition is the characteristic mode of cognition. By dint of repeated numerical simulation, using a wide range of assumptions about policy, world trading conditions, behavioral responses, and other factors, an ordered series of logically and behaviorally possible scenarios regarding the future forms in the mind. Some of these are plausible, others not. Some carry strong, albeit conditional, implications for policy. And while there has to be an element of forecasting, the object is not to produce a forecast as such but to provide a navigational chart that lays down alternative courses to desirable destinations, making it possible to skirt hazards and prepare for surprises.

Godley expects his forecasting work to be judged not on whether point estimates of changes in GDP and other measures turn out to be correct, but on whether the short- and medium-term policy problems seem, after the event, to have been correctly evaluated, whether the policy recommendations look right, and whether the case is clearly and convincingly argued.

"Any power I have to persuade others," Godley writes, "resides not in model `runs,' let alone in single point estimates, but in the verbal argument deployed. Although I work with a computer model, I aspire to the tradition of the great quantitative political economists such as Keynes, Kaldor, and, for that matter, Samuel Brittan, who argue their case with reason and rhetoric, supported with whatever evidence they think appropriate for the particular purpose in hand."

## Scholars

Senior Fellow **Walter M. Cadette**'s areas of special interest include health care, international trade, and regulation of financial institutions. In addition to his work at the Levy Institute, he is chairman of the Holy Cross Health System's investment review committee. Cadette is a retired vice president and senior economist of J.P. Morgan & Co. Incorporated and was editor of and contributor to its publications *Global Data Watch* and *World Financial Markets*. He received an M.A. from Georgetown University and did further graduate work in economics and finance at New York University. He is author of Public Policy Brief No. 30, *Prescription for Health Care Policy*, and No. 34, *Safeguarding Social Security*.

Research being conducted by Research Associates **Kris Feder** and **Michael Hudson** assesses the extent to which capital gains accrue as economic rent and, based on this estimate, the distribution of benefits of a capital gains tax cut to the real estate industry. In one study, Feder and Hudson calculate a value for economic rent in order to assess the effect of rent on consumer budgets. National Income and Product Accounts (NIPA) statistics show that rental housing has remained a steady 4 percent of national income since World War II, while the imputed rent for owner-occupied housing has risen from 4 to 8 percent. Bureau of Labor Statistics data show that during the same period rental costs have risen from 21 to 25 percent of disposable personal income. Feder and Hudson's initial findings suggest that the real estate gains of landlords and bankers during this period have been made at the expense of consumers and state and local governments. Their preliminary analysis from a second study, on the neglected role of real estate in the capital gains debate, reveals that 60 percent of capital gains accrues as real estate gains. Therefore, a reduction in the capital gains tax rate would benefit primarily the real estate industry, rewarding land speculation more than new direct investment.

Feder is an assistant professor of economics at Bard College. She received a Ph.D. in economics from Temple University. Hudson is a visiting scholar at New York University. He received a Ph.D. in economics from New York University. Feder and Hudson are co-authors of Public Policy Brief No. 32, *What's Missing from the Capital Gains Debate?* and with G. J. Miller, of *A Philosophy for a Fair Society* (Shepheard-Walwyn).

## Presentations and Publications by Levy Institute Scholars

Senior Scholar **L. Randall Wray** recently published the paper "Deficits, Inflation, and Monetary Policy" in the *Journal of Post Keynesian Economics* (Summer 1997). He presented the paper "Government as Employer of Last Resort: Full Employment without Inflation" at the Full Employment and Price Stability Conference at the University of Ottawa on October 17, at Columbia University on November 10, and at Lafayette College on November 5, where he also presented "Targeting Inflation: The Effects of Monetary Policy on the CPI and Its Housing Component" (Levy Institute Working Paper No. 164, written with Executive Director **Dimitri B. Papadimitriou**). At the Allied Social Science Association meetings in Chicago in January, he will present papers at two Association for Evolutionary Economics sessions, "Toward Full Employment in the 21st Century" and "Money and Taxes in Capitalist Economies."

Visiting Scholar **Mathew Forstater** presented the paper "Employment and Price Stability" at the University of Ottawa conference on October 17 and "Government as Employer of Last Resort: Outline of a Proposal for Full Employment with Price Stability" at the Leeds Postgraduate Conference, University of Leeds, on November 7. He will present "Employing the `Reserve Army': Structural Implications" at the Association for Evolutionary Economics session "Toward Full Employment in the 21st Century" at the ASSA meetings in January.

Cambridge University Visiting Scholar **Stephanie Bell** was a discussant at the University of Ottawa conference in October and will be a discussant at the Association for Evolutionary Economics session "Money and Taxes in Capitalist Economies" at the ASSA meetings in January. She will present the paper "The Role of the State and the Hierarchy of Money: Fiscal and Monetary Policy Implications of Paying Taxes in a Modern Economy" at the Eastern Economic Association meeting in New York City in February.

At the Social Science History Association meeting on October 17--19, Senior Scholar **Joel Perlmann** presented "Second-Generation Decline? A Reevaluation," written with Research Associate **Roger Waldinger**.

Research Associate **Lynndee Kemmet** presented "U.S.-Mexican Border Relations: Water, Immigration, Trade, and the Role of Agricultural Interests in the California-Mexico Desert Region" at the Northeastern Political Science Association annual meeting in Philadelphia, November 1997, and "From Agriculture to Tourism: Water and the Economic Transformation of California's Coachella Valley" at the Northeastern Agricultural and Resource Economics Association conference in Sturbridge, Mass., June 1997. Her article "Sustainability and Size: Are Small Farms More Sustainable?" written with Gerard D'Souza and John Ikerd, is to be published in *Sustainability in Agriculture and Rural Development* (Ashgate, forthcoming).

Research Associate **Karl P. Widerquist** and Michael A. Lewis, of the School of Social Welfare of the State University of New York at Stony Brook, presented "An Efficiency Argument for the Guaranteed Income" (Levy Institute Working Paper No. 212) at the annual meeting of the Society for the Study of Social Problems in Toronto in August.

## Congressional Policy Briefings

Levy Institute scholars met with congressional representatives and staff in Washington for the first in a series of briefings to inform policymakers about Institute research and to provide a forum for bipartisan discussion of significant policy issues. Topics reviewed at this meeting included:

- Innovative methods for financing infrastructure projects: taking of zero-interest mortgages by the Federal Reserve on state and local government infrastructure improvements; elimination of the tax-exempt status of municipal bonds used to finance state and local infrastructure investment or improvements
- Policy alternatives to bring Social Security into long-run financial balance while ensuring its continuing delivery of basic benefits for all retired workers
- Tax system alterations to address the problem of the lack of access to health care for millions of uninsured workers
- The role of profits in macroeconomic forecasting
- Changes in the Fed's decision-making process as analyzed by Preston Martin, former vice chairman of the Federal Reserve Board of Governors and member of the Levy Institute Board of Advisors

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## Correction

In James K. Galbraith's *Dangerous Metaphor: The Fiction of the Labor Market* (Public Policy Brief No. 36 and Public Policy Brief Highlights No. 36A), the title of Galbraith's new book was cited incorrectly in the note on the author. The correct title is *Created Unequal: The Rise of Wage Equality in America*. The book, sponsored by the Twentieth Century Fund, will be published in 1998 by the Free Press.