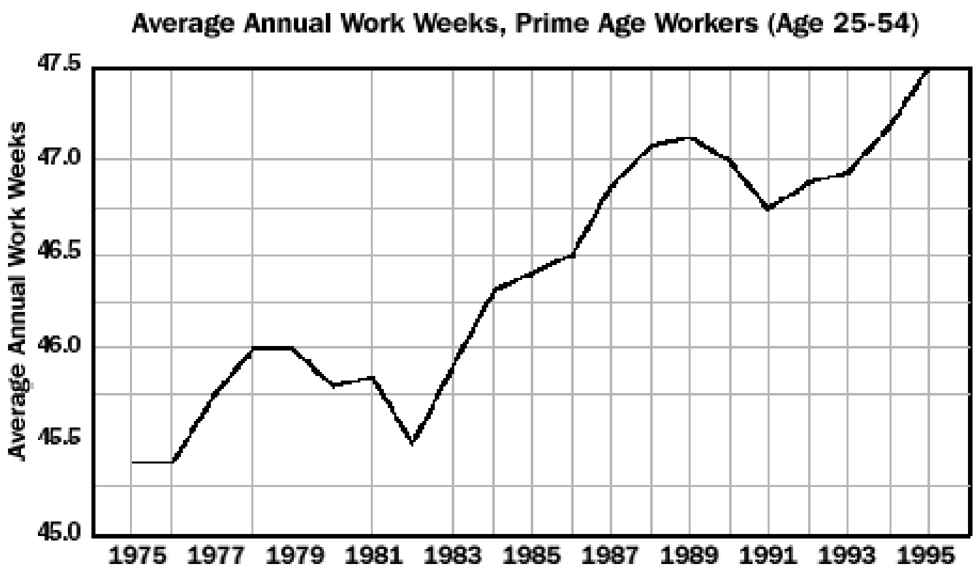
Report November 1997

Volume 7, Number 4



Source: Data from Current Population Survey and Panel Study of Income Dynamics, University of Michigan.

Research Associate Barry Bluestone and Stephen Rose find that job insecurity and stagnating wages are making Americans work more hours.

INSIDE

- Has the Federal Reserve outlived its function? Is there an alternative system, asks Congressman Tom Campbell.
- Distinguished Scholar Wynne Godley warns of the "headless monster" that European nations may create if they plunge into monetary union.
- It's time to recognize that racial intermarriage exists, asserts Senior Scholar Joel Perlmann.
- The key to reducing wage inequality and improving job quality is to encourage corporations to alter their business strategies, says Philip Moss.
- *The Levy Institute Forecast*, formerly *Industry Forecast*, becomes more reader friendly.

CONTENTS

The Levy *Report* Interview

Editorial

New Working Papers

Levy Institute News

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.

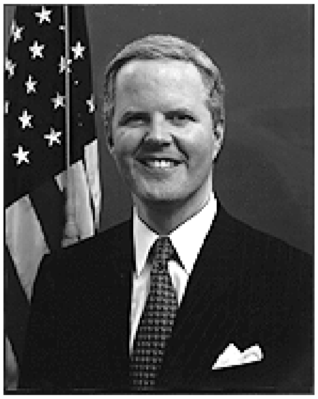
S Jay Levy, Chairman
Dimitri B. Papadimitriou, Executive Director

The *Report* is a quarterly publication of The Jerome Levy Economics Institute of Bard College and is produced by the Bard Publications Office.

Editor: Lynndee Kemmet
Text Editor: Judith Kahn
Photography: *Financial Times* Photograph, Lydia van der Meer

The Levy *Report* Interview

Tom Campbell Discusses the Federal Reserve, Tax Reform, Immigration, and Affirmative Action



Congressman Tom Campbell (R-Calif.) has gained a reputation as an independent-minded legislator. He was the only Republican in the House of Representatives who did not support this year's federal budget bill. He was also among the group of Republicans who sought to oust Newt Gingrich from his seat as House speaker. A former California state senator, Campbell has a doctor of law degree and a doctoral degree in economics. On June 25 he spoke with Sanjay Mongia, Levy Institute assistant director and Washington liaison. In the following excerpt from their discussion, Campbell presents his views on immigration and race-based preferences and outlines his suggestions for reforming the Federal Reserve and the federal tax system.

Mongia: You have expressed enthusiasm over a proposal by S Jay Levy to finance public capital investment by issuing interest-free credits directly from the Treasury Department to states and municipalities. What prompted your interest in this proposal?

Campbell: It's the financing side which is unique. The attraction of the proposal for most people would be the building of infrastructure by the cities, towns, and states--which is good. But that wasn't what attracted me. Rather, what captured my attention was the creation of a system for the Federal Reserve and the Treasury that is different from the present system. The present system creates money when the Federal Reserve prints a bill to pay for the purchase of a Treasury bond, and for every dollar that it prints it creates a dollar in debt owed by the United States. There is no reason for that and the Levy proposal changes that. Instead of creating debt owed by the United States for every dollar printed, it's a debt owed by cities, counties, and states who are building infrastructure and thus have the means to pay back the debt. It will lower the debt of the United States and it will create the infrastructure improvements as well. But it was really the monetary side that attracted me to the proposal.

Mongia: How would you respond to critics who may say that the plan is inflationary?

Campbell: The amount of lending is limited to less than the real growth rate, and as a result, it cannot be inflationary. The key here is that the nominal money supply must not increase faster than the sum of goods and services in society. If it increases at the same rate as the total amount of goods and services in society, then it is not inflationary. There's a more subtle criticism that the Levy proposal is so good that there is an incentive to keep doubling the level of infrastructure investment--which is a valid concern. At some point it could be inflationary; for example, if the annual expansion of the money supply is faster than the annual growth of gross domestic product. But we are way below those levels at the present time.

Mongia: Your interest in this proposal seems to be an extension of your interest in reforming monetary policy. Is the current system under which we conduct monetary policy outdated, and if so, how would you alter the specific mechanisms by which monetary policy is set?

Campbell: The present system is a vestige of the wars over free coinage of silver in the latter part of the nineteenth century. The debt-ridden farming states wanted to inflate and monetary policy was part of a political debate as much as fiscal policy is today. Bryan, for example, advocated the free coinage of silver, while McKinley was for maintaining the gold standard. The difficulty of having monetary policy in the political debate was that the invitation to inflate was obvious, and the nation succumbed to that invitation during the Civil War. With respect to the Federal Reserve, the United States took monetary policy out of the political branches and created a quasi-independent agency, which was considered a progressive reform. One would have to admit that the Fed was less democratic and lacked the supervision that the political branches are subject to, but, on the plus side, the Federal Reserve was less subject to the pressure to inflate. Over the years the Federal Reserve Board has sometimes increased the money supply too much and it has sometimes cut back the money supply too much, in the former case causing inflation, in the latter causing recession. But, on average, the Fed has led to a less fluctuating monetary policy--the peaks and troughs are small. Could there be a credible basis on which to restrict the political branches from abusing the money supply to inflate in order to get votes? If so, we don't need the Federal Reserve system of doing things.

Mongia: The debate over the size and scope of a tax cut has taken center stage in Washington. More fundamentally, though, how would you redesign the tax code to achieve the goals of greater simplicity, fairness, and efficiency?

Campbell: We should abolish the personal income tax, and substitute the current tax system with a national sales tax. From the national sales tax we should exempt food, medicine, and the cost of housing up to the median expenditures in a region. We would, thereby, not tax the poor and create a tremendous incentive to invest. We should tax consumption, not investment. Presently, we tax both because we tax income. If we only taxed consumption, we would have a lower interest rate that would lead to continued economic growth. We are a low net investing society, and a shift to a national sales tax would promote investment.

Mongia: Practically speaking, how high would a national sales tax have to be to ensure adequate revenue?

Campbell: Twenty percent.

Mongia: Do you think that it is possible to sell the American public on a 20 percent sales tax on purchases of goods and services in lieu of an income tax?

Campbell: It is if we make clear that the personal income tax is repealed. If it is not made clear that it is repealed, then I believe Americans would be right to worry that we'd end up with both the national sales tax and personal income tax. The latter might be lower for now, but eventually would creep back up. So in answer to a very fair question on your part, it's credible, but it can be sold only if we eliminate the personal income tax.

Mongia: Given the lack of empirical support, are you convinced that a reduction of the capital gains tax will fuel higher investment and job creation?

Campbell: I am, and I strongly favor a lowering of the capital gains tax rate. What we (Congress and the administration) are doing at this time, though, is combining the capital gains tax reduction with a tax credit for children, which has no economic growth effect. This amounts to a transfer which postpones the day of balancing the budget. So how much economic stimulus from the capital gains tax is worth postponing balancing the budget by the amount of the tax credit? Most members of Congress and President Clinton apparently have chosen to forsake balancing the budget for a tax cut.

Mongia: Are you concerned that a reduction in the capital gains tax may inevitably lead to wider inequality and further skew the distribution of wealth in this country?

Campbell: If the poorest increase their standard of living, it does not trouble me that the wealthy also improve their standard of living.

Mongia: Even though the levels of gain may be disproportionate?

Campbell: I repeat what I said. If the poorest improve their condition, I do not object to the fact that the wealthy improve their condition even more. During the Reagan and Bush years, the lowest quintile of income grew modestly, while the top quintile grew at a faster rate. So one can say look at this disparity. On the other hand, I'd say look at the bottom quintile; the poor got better. Compare that to the quintiles during the Carter years, during which no one experienced growth and the poor were very much worse off.

Mongia: Well, during the Clinton administration the economy has experienced robust job and wealth creation, unemployment has declined to 4.8 percent (the lowest in a quarter century), and in the last two years we've witnessed some modest wage gains for American workers. Whom do you credit for the strong economic performance? Also, if the Clinton years yield more equity compared to the Reagan years, wouldn't you prefer President Clinton's results to President Reagan's?

Campbell: The latter question is more difficult to answer because we don?t have comprehensive equity data for the Clinton years. I just don't know whether income disparity has grown more in the Clinton years than it did during the Reagan years. Without that information I can't answer the question.

Regarding who takes the credit, I'll be surprisingly nonpartisan. The president is entitled to credit. The president reappointed the chairman of the Federal Reserve Board who made elimination of inflation a top priority. After the national health care proposal, the president sent signals that he would not be advocating any other new massive spending programs. That established great confidence in the market and allowed the Fed to keep interest rates low. For that I give the president credit.

Mongia: The president has called for a national discussion on race. You were outspoken in your support of the voters of California in their elimination of preferences based on race, gender, and national origin. Among the results of the California civil rights initiative has been a dramatic drop in the number of African American applicants and admissions in the University of California system. Was this the intended and desired result of Proposition 209?

Campbell: No. However, there is an explanation of great importance that one must keep in mind: California should never have based admissions, even in part, on race. Not only did the process of preferences lead to a lot of unfairness to the races who otherwise would have been treated fairly and were not, it also postponed treating the systemic, endemic problem. As long as the University of California system could get its numbers of African Americans and Hispanic Americans correct, it did not need to concern itself with why no one was coming out of Oakland into Berkeley, why no one was coming out of Watts into UCLA, and why the neighborhoods were increasingly becoming separate economies. Therefore, in my judgment, when we undo the use of race by government, we need to replace it.

Previously, I have introduced legislation as a state senator and tomorrow (June 26) I will introduce legislation in Congress to replace the use of race. The numbers are down because there is no replacement in place. The replacement ought to be more than a cold record of grade point and SAT, which tell me only a little bit about you. Tell me what obstacles you had to overcome to achieve what you present in your grade point average and SAT. Tell me about your parents' income, about the situation in your high school, whether you worked a job, whether you had child care obligations because you have brothers and sisters? Tell me if you speak a second language. Tell me about yourself. Not that you're a member of this race or that one or that your skin is one color or another. Tell me about yourself.

Mongia: You're asking for much more subjective criteria, which may open up a Pandora's box and not satisfy the proponents of a wholly merit-based system.

Campbell: We must rely on something other than using somebody's race as a qualification. I know what that Pandora's box is: That Pandora's box is demeaning and racist. I don't want that one. It can be changed, if in its place they introduce a series of measures, such as alumni helping to conduct interviews that take into account personal experiences. Incidently, I'd add to that list experiences with discrimination. Tell me if you did not get a summer job because of the color of your skin or if you were kept out of a particular program based on race. I would rather try this new approach because we know what didn't work.

Berkeley and UCLA, which are the only two University of California campuses that used race in their admissions program, have predicted they will experience a drop in the average income of the entering class. They were accepting African Americans and Hispanics with higher incomes than the Asians and Caucasians who were kept out because they were not given minority preferences.

Mongia: Do you believe that some feature of affirmative action can be restructured or preserved in a way that would promote equality of opportunity without ensuring equality of outcome?

Campbell: It can be, but it ought not to be using race. That's what the 14th Amendment outlawed. But if you take my alternative approach, which takes into account overcoming obstacles, it's a step in the right direction. It's not the perfect answer, but I'm promoting equality of opportunity. Case in point: a candidate with a GPA of 3.9 whose parents are well off and and have no other children to take care of. Another candidate has a 3.2 GPA, had to work a job at night, and has seven brothers and sisters that are the responsibility of the parents. If I were admitting people into the University of California system, I would take the 3.2 who had to work a job at night and had seven brothers and sisters to take care of. It is subjective, but I'm getting toward equality of opportunity.

Mongia: Let's assume, for example, that the 3.2 GPA was someone who came from a disadvantaged background and the 3.9 GPA was someone who had a more privileged upbringing. You still wouldn't eliminate the complaints of unfair treatment if you admit the candidate with the lower score. You may deflect criticism that admission is race based, but it's still not strictly merit based.

Campbell: What I'm suggesting is that the 3.2 GPA is only relevant insofar as I know what obstacles you had to overcome to achieve the 3.2 GPA. It is merit based, but we consider other factors in a person's background. It's true that we don't enter this world equally, but I will not solve that problem by using the category of race.

Mongia: Your congressional district and state are both keenly aware of the socioeconomic effects of immigration. What, if anything, should be done to reform legal immigration policy?

Campbell: The total number of immigrants that we let in should be a function of our economy's ability to absorb both the costs and the value that the immigrant brings. Although my congressional district includes Silicon Valley and I recognize that many immigrants add value to our economy and society, I strongly believe that there is a need to change the categories. We need to shift more weight to preferences on the basis of skills needed in our country, as opposed to the current focus on preferences for admitting family members.

Mongia: Some who share your position on immigration, however, are troubled by your willingness to punish legal immigrants in the name of welfare reform. Is it not hypocritical for you, on one hand, to support an end to distinctions based on race and gender as in Prop 209 and, on the other hand, to want to distinguish one's citizenship status and deny legal immigrants welfare?

Campbell: The reason is that the family agreed to sponsor and support the immigrant before being admitted to the United States, and we have simply ignored that. When an immigrant comes in and the family sponsors that immigrant, the obligation should be upon that family to take care of that immigrant. Routinely we have said, no, we won't make the family responsible; if the immigrant falls on economic hard times, the state, county, or federal government will pick up the cost. But that's not playing by the rules. The rules are clear; there is family sponsorship. The only way to enforce those rules is to terminate benefits for those who are on welfare or seeking food stamps and who have a family sponsoring them capable of taking care of them. If we don't do that, then we're not serious about family sponsorship and its responsibilities. However, if the sponsoring family is itself not financially able to support the immigrant, then the individual should try to become a citizen. This is the last option, but not everybody can exercise even this option. Older folks, for example, might have Alzheimer's or other debilitating illnesses and may not be able to take the citizenship exam. There I make the exception.

Mongia: Economists have often charged that the level of understanding on economic issues is often woeful among public officials. From your experience, are economists simply being arrogant and underestimating your colleagues?

Campbell: I think my colleagues are underestimated. I won't comment on the arrogance of economists. It is fascinating, however, that attempts to convince are not tried more often. I have found in Congress that my colleagues overwhelmingly are open to persuasion by merit. Usually one will recognize when that's not the case, when a colleague has a political commitment that cannot be overcome by logic or fact. But certainly for everything except the headline issues, my colleagues are open-minded. Therefore, we economists, particularly the academics, ought to try harder. It is too easy to stereotype, and the stereotype of politicians is no fairer than the stereotype of academics.

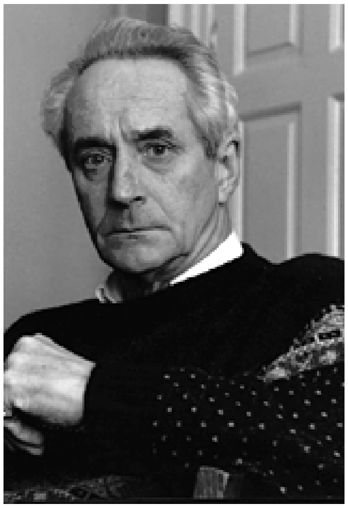
Contents

Editorial

Is the Monetary Cart Leading the Political Horse?

by Wynne Godley
Distinguished Scholar, The Jerome Levy Economics Institute

A version of this editorial appeared in *The Observer*, August 31, 1997.



Economic and monetary union in Europe with the adoption of a single currency remains a difficult subject that few people even pretend to understand, even at this late stage. The British Treasury recently published a paper called "The Pros and Cons of EMU," and as it contained a foreword by the Chancellor of the Exchequer Gordon Brown, claiming the paper to be "an admirably clear and objective analysis of the issues," I thought it deserved careful study.

Alas! Insofar as the paper is specific, the "pros" are nothing more than the standard list of trivial advantages (lower transactions costs and so on) that has been around for years. The "cons" consist of the loss of various powers to act independently--powers that are largely illusory in today's globalized world.

Yet this list of pros and cons hardly scratches the surface, as the Treasury paper implicitly recognizes but does not argue. "Europe," the paper states, "has embarked on an extraordinary undertaking" with possibly "momentous" implications for the UK. EMU will, perhaps, enable "a stronger and more integrated Europe . . . to exercise leadership on the global issues facing the world." This is heady stuff. But how are we supposed to move, in our minds, from the little world of savings on transactions costs to the colossal one of participating in the great sweep of history?

The lacuna I complain of is a familiar one. I have come to dread how, at conferences, the person put up to speak for EMU begins by trotting out these same pros and cons and then, under pressure, says that the real case for EMU (as the worldly wise all know) has nothing to do with any of that; the real case is "political." The speaker then goes on to say that once the single currency is in place, new political processes and appropriate institutions not yet on the agenda will grow naturally. Pressed further, the speaker gives the impression that one is being naive to expect anyone to be more specific at this stage.

The Treasury paper also takes the view that what happens after EMU is a question that can be shelved: "Adopting the single currency means, by definition, surrendering control over monetary policy, but no further loss of national sovereignty would necessarily be bound to follow. Europe's governments may well choose that course. Or they may choose otherwise." I don't think this covers the ground. First of all, if a government stops having its own currency, it doesn't give up just "control over monetary policy" as normally understood; its spending powers also become constrained in an entirely new way. If a government does not have its own central bank on which it can draw checks freely, its expenditure can be financed only by borrowing in the open market in competition with business firms, and this may prove excessively expensive or even impossible, particularly under "conditions of extreme emergency."

Second, while it will always be open to governments to negotiate a "further" loss of sovereignty later on, the Treasury paper fails to address the fact that new institutions are needed immediately to take up the powers abjured this time round. For instance, if Europe is not to have a full-scale budget of its own under the new arrangements, it will still have, by default, a fiscal stance of its own made up of the individual budgets of component states. The danger then is that the budgetary restraint to which governments are individually committed will impart a disinflationary bias that locks Europe as a whole into a depression it is powerless to lift.

A useful comparison can be made with the United States. Americans often point out that it would make no sense if each state had its own currency; so what, they ask, is all the fuss about? But the question should be asked the other way round. How would the United States make out with no president, no Congress, no federal budget, and no federal institutions apart from the Federal Reserve itself plus a powerful central bureaucracy?

The analogy is useful because the United States does so obviously need a federal budget as well as a federal bank, and the activities of the two authorities have to be appropriately coordinated. If there is a recession, remedial (expansionary) fiscal policy at the federal level is the only proper response. It is inconceivable that corrective action could be left to component states, which have neither the perspective nor the coordinating machinery to do the job. If there is a federal budget, there must obviously be a legislative and executive apparatus that executes it and is democratically accountable for it. Moreover, the need for federal institutions extends far beyond economic affairs. To take the point to extremes, the Union itself may come under threat and therefore needs armed forces plus appropriate machinery to deploy them effectively and responsibly.

I protest that the next stage in Europe cannot be left to chance and that whether or not we should go ahead with the monetary union depends crucially on what new arrangements are to be made. It is a grim thought that vastly greater power might be handed over to a headless monster. Think of the Common Agricultural Policy (CAP), which has been far and away the largest European project so far undertaken and which has been, for everyone unconnected with the farming industry, an extraordinary disaster. Defying every principle of free markets and free trade within Europe as well as between Europe and the rest of the world, the CAP has been enormously expensive in terms of consumer prices and budget contributions. It has seriously damaged the trade of developing and other countries, it has created conditions that foster corruption, and it has destroyed much of the British countryside (to no purpose) along the way. Few people understand how it works and nobody can keep track of it. The costs to Britain have been staggering, but nobody can work out just what they are. Is this the kind of thing that inevitably happens when an institution is given great power without proper accountability?

Contents

New Working Papers

"Multiracials," Racial Classification, and American Intermarriage--The Public's Interest

Joel Perlmann
Working Paper No. 195

As the time for the next decennial census draws near, the Census Bureau is searching for an answer to the question of how to categorize those Americans who are the product of an interracial marriage. Multiracial advocates have argued that census forms should either include a multiracial category or allow respondents to mark all racial categories that apply to them. But civil rights organizations have argued that such a change would weaken civil rights legislation, which is based on current racial categories, because it would confuse definitions of race and could affect minority numbers in the census data. Senior Scholar Joel Perlmann argues that it is time to acknowledge the fact that interracial marriage is becoming as common as interethnic marriage and thus should be treated the same way in the census. The failure of the Census Bureau to face this reality has led to a distortion in its projections of the racial mix of the American population by the middle of the next century.

Perlmann presents arguments to allow multiracial Americans to mark all racial categories that apply to them, just as Americans are now allowed to do when recording their ethnic background. Some oppose this approach because, they argue, it could inflate minority group numbers if mixed-race people are counted once for each category they mark. But Perlmann notes that this is the only way to assure that all multiracial people are included in minority counts. One possible way to avoid an overcounting of minorities would be to allocate a fraction to each group a person marks; for example, a person who lists himself or herself as white, black, and Native American would be counted as one-third of a person in each of those racial categories.

Skiki vono ko shtuvalo? [How Much Did It Cost?] The Seignorage Loss from Monetary Stabilization in Ukraine

David Alan Aschauer
Working Paper No. 196

As with many eastern bloc transition economies, Ukraine experienced rapid monetary expansion and high inflation after the Soviet Union's breakup. One result of this was that the government resorted to money creation to generate seignorage revenue. More recently, the government has pursued monetary stabilization, even though it might result in a reduction of government revenues through a decrease in seignorage revenue.

Visiting Scholar David Alan Aschauer uses quarterly data for the Ukrainian economy from 1993 to 1996 to determine just how much revenue the monetary stabilization policy has cost the government. He estimates that the revenue the government would have gained through seignorage had it kept money creation at its highest level and not pursued monetary stabilization has actually been rather low--averaging about 2 percent of gross domestic output (per quarter). The loss never went above 5 percent of output. Aschauer concludes that the long-term benefits of monetary stabilization will outweigh the recent costs.

Minimum Wage and Justice?

Oren M. Levin-Waldman
Working Paper No. 197

Debates about the minimum wage typically are based on economic issues. Those favoring an increase argue it will raise many Americans out of poverty by providing them with a living wage. Opponents argue that an increase in the minimum wage will result in higher unemployment as employers, forced to pay higher salaries, fire employees to keep overall salary costs the same as before the wage increase. Resident Scholar Oren M. Levin-Waldman argues that underlying the issue of the minimum wage is a question of values, and it is these values, not the economic aspects, that should be addressed in the minimum wage debate.

According to Levin-Waldman, what is really at the heart of the minimum wage debate is an American political philosophy that stresses individualism--and individual responsibility--rather than community effort. Opponents of increasing the minimum wage argue that people are free to chose to act in ways that will get them well-paid employment, such as retraining themselves or improving their skills. But others question that this freedom exists and counter that wage rates are in reality controlled by those who control capital and so there is little the individual can do. Levin-Waldman argues that in setting minimum wage policy, we must first ask what values we as a society want to promote and then ask if the minimum wage helps us promote those values. He concludes that if our goal is to promote a just society, then the minimum wage can help us achieve that goal.

Earnings Inequality and the Quality of Jobs: The Status of Current Research and Proposals for an Expanded Research Agenda

Philip Moss
Working Paper No. 198

Inequality in earnings is increasing and job quality--in terms of job security, upward mobility, and benefits--is decreasing. Many researchers, in seeking to understand these trends, have focused on changing market forces, such as technological innovation and global competition, as possible explanations. Some argue that a decrease in restraints on market forces, such as unions, have made it possible for wages to be pushed down. Philip Moss, of the Center for Industrial Competitiveness at the University of Massachusetts Lowell, argues that market forces alone do not explain the deterioration in wages and job quality experienced by many workers.

Moss presents as an alternative explanation strategy decisions made within firms and industries. Researchers often argue that corporate strategies are a reaction to outside market forces, but Moss points out that case studies show that firms within an industry do not always develop the same strategies. Wages and job quality vary among firms in the same industry, because those firms have different business strategies. This indicates that firms can make choices regarding their business strategies and treatment of workers and that decisions are not dictated entirely by market forces. Moss argues that if this is correct, it might be possible to get increased earnings equity and job quality by influencing corporations to alter their internal strategies with regard to pay structures, skill formation, and the implementation of technology.

Good Jobs and the Cutting Edge: The U.S. Machine Tool Industry and Sustainable Prosperity

Robert Forrant
Working Paper No. 199

The decline of the American manufacturing sector has contributed to the loss of well-paid, stable jobs since the late 1970s. Robert Forrant, of the Department of Regional Economic and Social Development and the Center for Industrial Competitiveness at the University of Massachusetts Lowell, examines the decline through a case study comparing the American and Japanese machine tool industries.

Although the American machine tool industry was preeminent throughout much of the twentieth century, Japan's machine tool industry has taken the lead in the past few decades because it has successfully developed and marketed new technology. While American manufacturers focused on producing for government or for select industries, such as automobiles and aerospace, Japanese manufacturers--often with government financial support--worked closely with civilian customers to develop machine tools that were technologically advanced, reliable, inexpensive, and usable by a wide variety of industries and small businesses. In addition, Japanese machine tool manufacturers have shown a greater willingness to invest in employee skills, to include such skilled employees in production and development decisions, and to postpone short-term profits for long-term gains. Forrant concludes that the manufacturing decline in the United States is due to structural problems, not cyclical business problems.

Second Generations: Past, Present, Future

Roger Waldinger and Joel Perlmann
Working Paper No. 200

Underlying some of the recent antiimmigration fervor has been the belief that immigrants lack the educational and employment skills needed to succeed in the American economy and that they and their children face a future of unemployment and poverty. A number of commentators and researchers have expressed concern that compared to the children of past generations of immigrants, the children of more recent immigrants appear less able to adapt to American society and less able to acquire the skills they will need as the economy shifts toward high-skill, knowledge-based jobs. Research Associate Roger Waldinger and Senior Scholar Joel Perlmann examine the reasons for this pessimistic view of the second generation's future and find that the pessimism is not justified.

Researchers who argue that the second generation faces a bleak future base their view on comparisons with the past. The manufacturing jobs that once lifted children of immigrants out of poverty have disappeared and thus that ladder to success is no longer there. Waldinger and Perlmann note that there were in the past, and there are today, alternative ladders to success. In addition, education is more available today than in the past. And many children of immigrants (most notably among Asians) have taken advantage of this educational opportunity and are in a position to succeed.

The authors note, however, that some immigrant groups follow divergent patterns of adaptation. Those most at risk for lack of success or assimilation into an underclass are the children of poor, low-skill immigrants. Mexican immigrants tend to be at the botton of the income and skill distribution and they are the largest component of the new immigrant population. Their low position on the skill ladder is one reason why data on the second generation as a whole seem to present a bleak picture. Were it not for the inclusion of Mexican immigrants in the data, the second generation would look much like the rest of the American population in socioeconomic characteristics.

Organizational Learning and International Competition: The Skill-Base Hypothesis

William H. Lazonick
Working Paper No. 201

Researchers examining the problem of income inequality in the United States give essentially two explanations for why this inequality has increased. One is that American innovation has waned, which has made it difficult for American industry to compete in the global economy. The other is that as businesses replaced workers with new technology, many well-paid jobs disappeared. While both international competition and technological change have affected the distribution of income, William H. Lazonick, of the Center for Industrial Competitiveness at the University of Massachusetts Lowell and INSEAD, argues that an even more important cause is the failure of American industry to invest in broader and deeper skill bases.

American corporations have focused investment on the development and employment of technology. Investment in worker training has tended to be concentrated on managers rather than shop-floor workers and on developing specific skills rather than broad-based or multiple skills. Japanese firms, on the other hand, have invested in the development of broad-based skills for workers at all levels. This investment has paid off in terms of organizational learning; the integration of managers and shop-floor workers into the learning process has led to greater innovation and efficiency in the production process. As a result of this difference in investment strategies, American corporations have lost preeminence in the global economy, which has negatively affected the wages of American workers.

Aggregate Demand, Investment, and the NAIRU

Malcolm Sawyer
Working Paper No. 202

The NAIRU: A Critical Appraisal

Malcolm Sawyer
Working Paper No. 203

The nonaccelerating inflation rate of unemployment (NAIRU) derives from economic theories that argue that when unemployment falls below a certain level, the rate of inflation accelerates. One cannot have both a low inflation rate and a low unemployment rate. According to the NAIRU, low unemployment leads to pressure for higher wages, which raises costs and leads to higher inflation. Economists have long debated the existence of the NAIRU and its rate, that is, the unemployment rate below which one cannot go without risking a higher rate of inflation. From this debate have emerged numerous models that attempt to determine this rate.

In these two working papers Visiting Scholar Malcolm Sawyer examines these various models and concludes that there are weaknesses in many of the theories on which they are based. Most importantly, NAIRU theories fail to consider aggregate demand and the role it plays in determining the level of unemployment. Sawyer warns that policymakers should be cautious when using NAIRU theories as policy guides. Policies that seek to control inflation by promoting higher levels of unemployment could cause the NAIRU to rise and to sustain higher levels of unemployment.

The Growth in Work Time and the Implications for Macro Policy

Barry Bluestone and Stephen Rose
Working Paper No. 204

Economic theory had long held that when unemployment rates were low, wage pressure would increase and inflation would soon follow. But the current state of the American economy--low unemployment and low inflation--implies that economists are wrong. Research Associate Barry Bluestone and Stephen Rose, of the Educational Testing Service, argue that the problem is not the theory but the method used to measure labor supply.

The unemployment rate is the traditional measure used by economists and policymakers to determine the tightness of the labor supply--the lower the rate, the tighter the labor market. Bluestone and Rose assert that a better measure of labor supply is the number of hours people work. Others have taken this approach, but the authors find that some measures of hours worked, such as the Current Population Survey (CPS), have not been entirely accurate, with most studies overestimating hours. Using data from 1967 to 1989 collected by the University of Michigan's Panel Study of Income Dynamics and recent CPS data and controlling for business cycle effects, Bluestone and Rose find that job insecurity and stagnating wages have made Americans willing to work extra hours and extra jobs at their current pay rate to build up nest eggs for times of unemployment or to maintain their lifestyles. This overwork and underemployment was found to be true among both men and women and across the workforce.

Bluestone and Rose conclude that the rise in labor force participation and decline in unemployment have accounted for a smaller share of the increase in hours worked in this economic expansion than they have in past expansions. The authors see no sign of abatement of the current trends in global competition, technological change, weakened labor unions, and industry deregulation. Therefore, the upward trend in hours worked is likely to continue. This means that economic growth can continue without risk of inflation.

Macroeconomics without Equilibrium or Disequilibrium

Wynne Godley
Working Paper No. 205

Distinguished Scholar Wynne Godley uses a simulation model to describe the role that bank money and bank loans play in macroeconomics when decisions by households and firms are taken under conditions of uncertainty and when production, distribution, and investment are set in historical real time. The model aims to integrate the theory of money and finance into the theory of income determination in what Godley says may broadly be called the Keynesian tradition. The model can be used, he argues, to provide a framework for the study of fixed investment, the capital stock, and equity or to represent productivity changes and wage and price inflation. When another country is included, it can also be used to establish a framework for studying the determination of exchange rates.

Are Good Jobs Flying Away? U.S. Aircraft Engine Manufacturing and Sustainable Prosperity

Beth Almeida
Working Paper No. 206

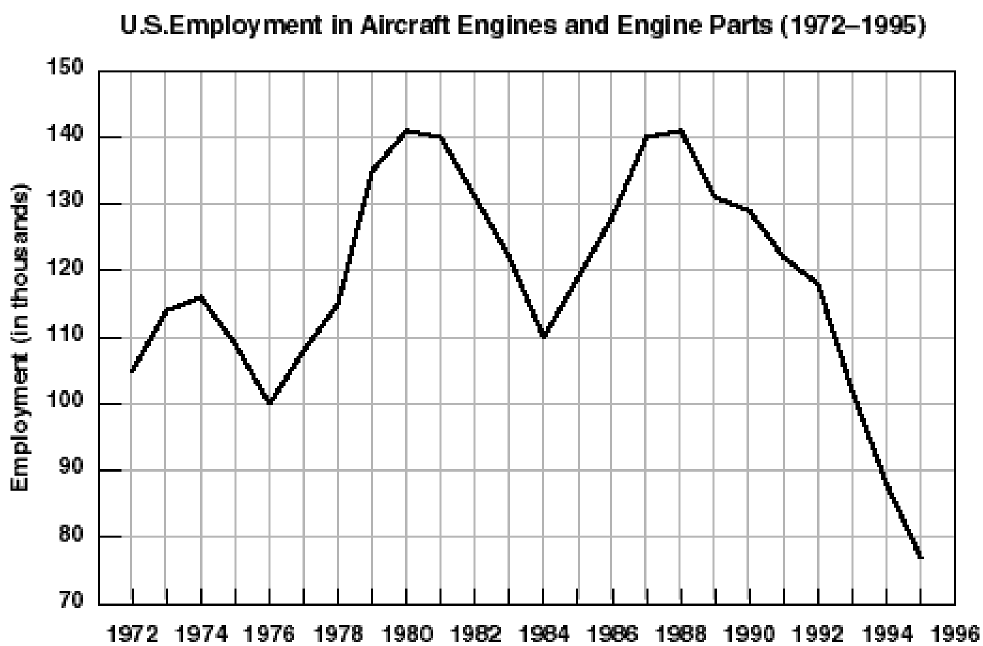
Employment in the American aircraft engine manufacturing industry has plummeted since its 1988 peak despite the fact that the two largest firms in the industry are American based. Beth Almeida, of the Department of Economics at the University of Massachusetts Amherst and of the Center for Industrial Competitiveness at the University of Massachusetts Lowell, examines this loss of skilled, well-paid jobs and concludes that investment and marketing strategies pursued by American manufacturers are its key causes.

In the early years of the American aerospace industry the high cost of developing and producing aircraft engines was offset by government financial support for technological developments that could be used for military purposes. But this financial support began to wane in the post-

Vietnam era as the military was downsized. Unwilling to take on investment risks alone and facing increased global competition with deregulation of the airline industry in the late 1970s, American aircraft engine manufacturers sought partnerships with foreign firms.

In the first collaborative ventures foreign firms, specifically European and Japanese, provided financial support in exchange for contracts guaranteeing them business as suppliers of engine parts. Over time these foreign manufacturers became partners in development and production. As a result of these partnerships, European and Japanese manufacturers gained access to American technology and expanded their production of aircraft engines and parts, which resulted in decreased production at American manufacturing plants and the loss of jobs for blue-collar workers who assembled the engines and scientists and engineers involved in research and development.

Efforts by American manufacturers to regain the lead in production and development have not been successful because they have failed to involve workers at all levels in these efforts. Rather than encouraging collaborative efforts between shop-floor workers and management to enhance development and production, American manufacturers have continued to view shop-floor workers as nonessential employees whose work can be contracted out. Reorganization and investments in worker skills and training have focused almost solely on management.



Source: Census of Manufacturers 1987, 1992; 1994, 1995 Annual Survey of Manufacturers.

Reasserting the Role of Keynesian Policies for the New Millennium

Philip Arestis and Malcolm Sawyer
Working Paper No. 207

A common topic of debate among policymakers and economists is the role that government should play in the economy if the goal is full employment. Some argue that the economy runs best with less government intervention, but Philip Arestis, of the University of East London, and Visiting Scholar Malcolm Sawyer argue that full employment is not possible without government intervention because a number of constraints in a market economy prevent it from achieving full employment. The authors identify five key constraints: the inability of a market economy to ensure an adequate level of demand; the tendency for inflationary pressures to develop as the market moves toward full employment; balance of trade constraints that limit the level of economic activity to ensure that the level of imports is compatible with the level of exports; the tendency in some market economies for unemployment to serve as an incentive for workers to produce; and a shortage of capital stock needed to sustain full employment.

Arestis and Sawyer present a number of policies that governments could adopt in order to overcome these constraints and achieve full employment. Among them are monetary policies that promote low interest rates, an international monetary system that ensures stability in exchange rates and encourages trade, creation of some form of centralized wage-setting institution, industrial policies that encourage research in and development of new products, and reorganization of the workplace to allow all levels of employees a role in the decision-making process. Adoption and implementation of these policies will require the commitment of both policymakers and the electorate; they will also require international cooperation because globalization affects the ability of states to carry out successful policies.

Contents

Levy Institute News

A New Look for the Forecasting Center's Publication

The Levy Institute Forecast, formerly *Industry Forecast,* the Forecasting Center's 48-year-old publication, has been expanded and enhanced. The changes are designed to make the publication more useful to readers and to meet the Forecasting Center's goals of educating readers and providing them with an alternative perspective on the economy. It is another step toward the center's long-term objective of bringing more attention to an economic research approach that emphasizes profits.

The Levy Institute Forecast offers a penetrating look at what drives the economy from a perspective focused on the flows of funds that become aggregate profits. The new format shows readers more explicity how the Forecasting Center research team, led by Vice Chairman and Director of Forecasting David A. Levy, with Chairman S Jay Levy, arrives at its profits forecast. It also provides an at-a-glance bottom line on the profits outlook. The analysis, observations, and forecasts in *The Levy Institute Forecast* will continue to provide decision makers with unique insights into the complex economic environment.

The Forecasting Center has added new researchers to its staff. Pavlina R. Tcherneva and Jesse D. Brackenbury joined the center as research fellows. Tcherneva graduated with honors from Gettysburg College, where she earned degrees in economics and mathematics. Her research has been in the areas of fiat currency and monetary policy. Brackenbury graduated with honors from Williams College, where he earned a degree in political economics. His past research has been in environmental economics.

Scholars Participate in Debates-Debates

Executive Director **Dimitri B. Papadimitriou** and Assistant Director/Washington Liaison **Sanjay Mongia** participated in recent segments of *Debates-Debates*, the national television program. In a segment on the question "Is the consumer price index reliable?" Papadimitriou joined with Robert Gordon, a member of the Boskin Commission and a professor of economics at Northwestern University, and William A. Niskanen, chairman of the Cato Institute, in arguing no. Arguing yes were Eugene H. Rotberg, a member of the Levy Institute Board of Advisors and a former vice president and treasurer of the World Bank; Jeffrey Madrick, editor of *Challenge*; and Dean Baker, a research associate at the Economic Policy Institute.

Mongia participated in a segment in which the question was "Should America mostly admit skilled and/or educated immigrants?" Arguing yes were Mongia; Richard Estrada, a member of the U.S. Commission on Immigration Reform and an editorial writer with the *Dallas Morning News*; and Roy Beck, author of *The Case Against Immigration*. Arguing no were Eugene H. Rotberg; Frank Sharry, executive director of the National Immigration Forum; and Jagdish Bhagwati, a professor of economics and political science at Columbia University.

A Lecture by Joel Perlmann

In a lecture entitled "The Mixing of People: Intermarriage and the Making of Americans--History, Prospects, Policy," Senior Scholar Joel Perlmann presented findings from his research into the issue of interracial marriage and racial classification in the decennial census. He stated that he believes interracial marriage will continue to increase, which will result in an American population by the middle of the next century that is much more racially mixed than current Census Bureau projections estimate. Census Bureau projections are wrong because they fail to take into account this rise in interracial marriages, Perlmann said. These projections assume that there will be no mingling of races. But interracial marriages are likely to become as common in the future as interethnic marriages are today.

The issue of interracial marriage is an important one because of civil rights legislation that has been designed to protect individuals of particular races. How one is categorized racially determines one's legal status with regard to this legislation. For this reason the government is having a difficult time solving the debate regarding how the children of mixed-race marriages ought to be counted in the census. While Perlmann questioned the relevance of having government estimate the future racial composition of the American population, he said some form of data collection that keeps track of the racial composition of the population is necessary. Without such information it will be difficult to see how minority groups, especially African Americans, are faring under civil rights legislation.

New Members of the Research Staff

Cambridge University Visiting Scholar **Stephanie Bell** is applying the approach of Hyman P. Minsky to an analysis of reserve accounting at the Federal Reserve and its importance for monetary policy formation. Her work at the Levy Institute will explore the relationship between government deficit spending and bank reserves and the implications of this relationship for monetary policy.

Mathew Forstater is a visiting scholar from Gettysburg College. His research and publications have been in the areas of economic theory, history, and policy. In his work at the Levy Institute, he will use a historical and interdisciplinary approach to study full employment policies in the face of deficit reduction and continuous economic change.

Jan A. Kregel is a visiting senior scholar from the University of Bologna, Italy. His work will focus on European monetary union.

Senior Scholar **L. Randall Wray** is working on several projects in the areas of employment and monetary policy. He is studying policies to promote full employment focusing on Hyman P.

Minsky's "employer of last resort" proposal. He and Executive Director Dimitri B. Papadimitriou currently are assessing 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. They will then use this research to make policy suggestions with regard to the retirement age, the Social Security program, and macroeconomic employment policies. They will also continue their work on the appropriateness of existing price indexes as targets for monetary policy. Wray has been an associate professor at the University of Denver. He is the author of many Levy Institute publications on monetary policy and community banking.

Events

October 23-25, Immigration Symposium, "The Second Generation Then and Now: Education and Early Job Market Experiences" (an academic meeting by invitation only). A summary of the symposium proceedings will appear in the February 1998 issue of the *Report.*

April 23-25, 1998, Eighth Annual Hyman P. Minsky Conference on Financial Structure. Registration and conference information will appear in the February 1998 issue of the *Report* and on the Institute's web site as it becomes available.

Contents