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INSIDE:

The battle over a balanced budget amendment resumes as the amendment comes up for a vote again. In this issue:

- "The general public doesn't understand (and maybe shouldn't be expected to understand) the difference between balancing the budget, which may well be a good idea, and having an amendment that forces budget balance, which is a horrible idea," says Alan S. Blinder, member of the Levy Institute Board of Advisors and former vice chairman of the Board of Governors of the Federal Reserve
- "Like the movie entrepreneur who thought he could clone dinosaurs and keep them under control in a zoo theme park, the proponents of the balanced budget amendment are dealing with issues that are far more complex, far-reaching, and dangerous than they recognize," says Vice Chairman and Director of Forecasting David A. Levy
- "If we truly believe our government is fiscally irresponsible, we must not delude ourselves into believing that a constitutionally forced balanced budget will solve this problem," says Executive Director Dimitri B. Papadimitriou

Some recent research reported on in this issue:

- Research Associates William J. Baumol and Edward N. Wolff find that there is more substance to the public's fears that new production techniques can threaten jobs than is acknowledged by many economists
- William Lazonick and Mary O'Sullivan warn that the threat to the prosperity of American corporations lies less in low-wage competition from abroad than in the corporations' failure to invest in organizational learning

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With this issue, the Report changes from a bimonthly to a quarterly publication. Issues will appear in February, May, August, and November.



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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Dimitri B. Papadimitriou, Executive Director

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The Levy Report Interview

Alan S. Blinder Discusses the Balanced Budget Amendment, the Federal Reserve, Tax Reform, and the Role of the Economist in Policy Making



Alan S. Blinder, a member of the Levy Institute Board of Advisors, served as a member of President Clinton's Council of Economic Advisers and as vice chairman of the Board of Governors of the Federal Reserve. He is the author of several books and a former columnist for Business Week and The Boston Globe. Blinder is currently Gordon M. Rentschler Memorial Professor of Economics at Princeton University. On December 19, 1996, Blinder discussed a number of important economic issues with Senior Research Associate Frances M. Spring. Excerpts from their conversation follow.

Spring: Although emphasis has shifted slightly in recent years, most academic economists focus on theory in their research as opposed to application. In light of this, what advice would you give an academic economist thinking about entering the realm of policy making?

Blinder: I think the first thing such a person should realize is that even though, as a theorist might put it, the real world is a special case, it is, nonetheless, an intensely interesting special case. Economists have quite a bit to contribute to the explanation of what goes on in the real world. Not all, but most of what economists have contributed in the policy realm is their continuing emphasis on the simplest ideas of economics, such as comparative advantage, awareness that demand curves slope down and supply curves slope up and that certain things happen when you interfere with free markets, externalities, opportunity costs, and so on. You could go on and on with a list such as this. People in policymaking circles frequently need to be reminded of these ideas.

Spring: So you would say keep it simple and stick to the basic concepts of how the economy works and how certain aspects of the economy will affect policymakers' ability to frame policy.

Blinder: You don't have to keep it simple in your own mind or when you are working with a technical staff, but when you bring it to the policy or political level, yes, keep it simple.

Spring: Is a balanced budget amendment good economics, good policy, good politics, all of the above, or none of the above?

Blinder: To my mind the balanced budget amendment is clearly horrible economics, terrible policy, and, unfortunately, good politics. The general public doesn't understand (and maybe shouldn't be expected to understand) the difference between balancing the budget, which may well be a good idea, and having an amendment that forces budget balance, which is a horrible idea. In that lack of understanding lies what makes such an amendment good politics and so dangerous: it sounds good. With so much political energy being directed toward the goal of balancing the budget, it is hard to educate the public as to why balancing the budget through a constitutional amendment is not a good idea.

Spring: And why isn't it a good idea?

Blinder: There are many reasons, but the principal one is that the amendment would end the automatic stabilizing effect of the budget.

Spring: You served as vice chairman on the Board of Governors of the Federal Reserve for

several years. Do you feel that the actions of the Federal Reserve should be more open to public scrutiny? For example, should the Fed issue more detailed notes or should records of meetings be published sooner? And should there be more explicit rules mandating what inflation and unemployment zones the Fed should try to hit?

Blinder: I have long been a strong believer in more openness at the Federal Reserve, and now, after having served on the Federal Reserve Board, I feel even more strongly about it. More information might not necessarily mean more detailed notes or records of meetings, and it certainly does not mean cameras in the FOMC [Federal Open Market Committee] meeting room. What it does mean to me is a fuller and probably more timely explanation of FOMC decisions. What were the factors in making a decision? What was the "model" of the economy that was used to come to that decision? What objectives does the Fed think will be served by the decision? How does the decision fit into the broader strategy?

Spring: So, do you feel that the press announcements following FOMC meetings do not provide adequate information about what the Fed is doing and in what direction policy is going?

Blinder: First of all, those announcements are made only if policy is changed. When policy is not changed, usually no explanation is given. The Fed could give an explanation, but generally it does not. If you read the press announcements, they usually contain several sentences of boilerplate and then one or two substantive sentences that actually have meaning. Second, these sentences tend to be a little cryptic and therefore are not infrequently misinterpreted by Fed watchers. The Fed should go to greater lengths to explain its actions better and in plain English.

Spring: Why do you think your comments at the Jackson Hole conference that the Fed needs to pay attention to employment were generally perceived as being inflammatory?

Blinder: I think that to some extent I was stating explicitly and openly what is really common practice and common belief, but is often hidden in a cloud of contrary rhetoric. Central bankers around the world-some to a greater, some to a lesser extent-do behave as though employment matters, as well they should. Some of them like to use words suggesting that they do not behave in that way. I, however, think that deeds and words should match. Apparently, being up front about what was happening touched a few nerves. I don't think it should have; there was nothing at all even slightly inflammatory about what I said at Jackson Hole.

Spring: No. I think the fact that the comments caused such an uproar took quite a few people by surprise.

Blinder: I was rather surprised myself!

Spring: Moving to a slightly different topic, is tax reform necessary?

Blinder: If you use the term "necessary," I think not. If tax reform is defined as a major change in the nature of the tax code, I'm not convinced that it is even appropriate. I'm not convinced that the basic type of taxation we now have—a progressive income tax—is a bad idea and that a flat tax or a consumption tax or value-added tax would be, on net, an improvement. There are certainly areas in which any one of these would be an improvement over what we have today, but there are also other areas in which what we have now is probably better. On the other hand, I think it would be appropriate to "fix" the progressive personal income tax in a way similar to what we did in 1986. I was a big booster of the 1986 tax reform and if we could do something similar, the tax code could be made simpler, fairer, probably flatter, and more efficient.

Spring: There seems to be a political consensus that a growth ceiling of 2.2 to 2.5 percent is both realistic and appropriate. Do you agree?

Blinder: I actually don't agree with that statement. I think there's a growing consensus among economic technicians that such a number is realistic and appropriate. Economists who have looked at this issue believe that the long-run trend growth rate of the economy is probably around 2.25 percent, and I agree with them. But, if anything, there is political agreement (though not consensus) on both the left and the right that growth in the 2.2 to 2.5 percent range is too low. Critics on both sides of the political spectrum are saying that the government is being defeatist by accepting a trend growth rate as low as 2.25 percent and that the Fed is unduly holding back growth when it should be letting the economy grow faster.

Spring: Do you think that Wall Street believes that a 2.25 percent trend growth rate is just fine and that anything above that would be dangerous?

Blinder: By and large yes, if by Wall Street you mean the bond market. There are some Wall Streeters who argue for much higher growth, but I think most agree with the majority of economists on this issue.

Spring: There appears to be increasing concern, at least in the print media, about the credibility of economic statistics. For example, recent articles have noted problems with export data, earnings, and GDP data, not to mention the CPI. To what extent do you feel current data are unreliable and how should policymakers respond to any discrepancies?

Blinder: I think the economic data are unreliable to a considerable extent. At least some of that unreliability, if not fixable, could be substantially ameliorated by devoting more resources to data collection and processing. For example, the service sector of the U.S. economy now accounts for over 60 percent of GDP and well over that in terms of employment. Yet there are fewer statistics generated about the service sector than about the manufacturing sector, which is only one-third as large as services in terms of GDP and even smaller in terms of employment. The allocation of the nation's statistical resources appears to be somewhat obsolete and needs to be changed. If the relevant statistical agencies were given greater resources, they could address some of these problems. But other types of unreliability cannot be so easily improved. There are very vexing

questions, for example, those posed by the Boskin Commission about quality adjustments in price indexes. You can chip away at that problem, but it's an extremely difficult problem and not one that we could solve quickly by just "throwing money at it."

Spring: You say that some data series might be improved by devoting more resources to them. Given the current fiscal climate, do you think that data-collecting agencies are going to be able to spend more money to solve these problems or will any attempts at improving the data be made by shifting resources?

Blinder: In the current political climate, the likelihood that we're going to spend more in total is extremely small. So I think if more resources are going to be devoted to any statistical problem, they will have to come from shifting. My personal preference would be an expansion in some of the statistical budgets, such as those of the Bureau of Economic Analysis, Bureau of Labor Statistics, and Census Bureau. But I don't think that's in the cards.

Spring: What is your opinion about research that finds that interest rates have little or no effect on output?

Blinder: I think it's quite interesting. The findings may have something to do with looking for such effects in the wrong places. But I'm not quite sure. The simple economics that we teach emphasizes the interest sensitivity of business investment spending, but there is a statistical controversy about whether this is true. Nonetheless, it appears that when a central bank—be it the Fed or the central bank of another country—tightens money and credit by raising short-term interest rates, aggregate demand slows down after a lag period. So something is happening. I suspect [the discrepancy] may arise because economists have concentrated their research efforts on business investment and haven't paid as much attention to housing and consumer durables, especially autos—sectors that may be more interest sensitive.

Spring: How long do you think the lag generally is between a rise in interest rates and a slowdown in aggregate demand?

Blinder: I think of interest rates as usually having negligible effects on aggregate demand for the first 3 to 6 months and sizable effects 12 to 24 months after the tightening.

Spring: That would seem to have quite substantial implications for monetary policy.

Blinder: Titanically important implications for monetary policy. The lag forces monetary policy to look forward and to base decisions on forecasts even though everybody knows the forecasts are not as accurate as we'd like them to be. There simply is no choice.

Spring: So the Fed would have to rely on one- to two-year forecasts. Do you think the Fed has adequate forecasting ability to be able to conduct sound monetary policy?

Blinder: Probably yes, although nobody, including the Fed, has the capability of generating accurate economic forecasts two years ahead. If your standards are not too exacting, I think a stabilizing monetary policy could be based on even mediocre forecasts-although, obviously, if the forecasts are bad enough, the policy is going to be bad. It needs to be recognized that there is a risk in playing this game. You can take a policy action that would have been the right thing to do if the forecast had been accurate, but because it turns out to be a poor forecast, you wind up doing the wrong thing and doing more harm than good. That part of the conservative criticism of stabilization policy is correct. The question is how important is it in practice. My reading of history-and certainly the recent history of the Fed-is that even with mediocre forecasts, if there are no major shocks pushing the economy away from the previously expected growth path, the Fed can still do a pretty good job.

Spring: If a large shock happens, is it your opinion that, given the long lag between enacting policy and having its effects felt on the economy, the Fed should not respond to the shock?

Blinder: No, because the economy is like a slow-moving ocean liner-it doesn't turn on a dime. For example, if we were to have a big oil shock next quarter, the effects of that shock would be felt for quite a long time. So even though the Fed can't react until after the fact, it can probably still do some good.

Spring: In the debate about the European Union (EU), some assert that the Maastricht criteria effectively make it impossible for any country in the union to provide a fiscal stimulus to its economy. Under that arrangement, will European nations be able to reduce their record levels of unemployment without devaluing the new currency?

Blinder: If done correctly, the Maastricht treaty should not make it impossible for European countries to provide fiscal stimulus. If, for example, a country's average or baseline deficit was substantially below 3 percent of GDP [the agreed-upon maximum ratio for EU countries], that country would be able to raise its deficit to 3 percent of GDP to provide fiscal stimulus to the economy. That's a possibility, but whether it will actually happen is an entirely different question. I think it will be very difficult to apply fiscal stimulus in the short run. However, in appraising something like a monetary union, you ought, at least in principle, to look at a long stretch of history-not at what's going to be true for the next year or two, but what's going to be true for the next decade or more. In a time frame like that I don't think Maastricht rules out fiscal stimulus, although for the next year or two I think it does. The need to get the Euro off to a good start, which requires establishing it as a hard currency, will mean that monetary policy will be constrained as well. So I think it's going to be difficult in the short run for Europe to reduce unemployment.

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Debates-Debates

The Balanced Budget Amendment



(Left to Right) Chairman of the Cato Institute William A. Niskanen, Ohio State Treasurer J. Kenneth Blackwell, and former Delaware governor Pete Du Pont

The balanced budget amendment was the topic of two segments in January of *Debates-Debates*, the nationwide public policy television program. The first segment, "Is the Balanced Budget Amendment a Recipe for Disaster?" featured **David A. Levy**, Levy Institute vice chairman and director of forecasting; U.S. Representative **Maurice Hinchey** (D-N.Y.); and U.S. Senator **Daniel Patrick Moynihan** (D-N.Y.) arguing yes. Arguing no were former Delaware governor **Pete du Pont**; Ohio State Treasurer **J. Kenneth Blackwell**; and **William A. Niskanen**, a member of President Reagan's Council of Economic Advisers and currently chairman of the Cato Institute. In the second segment, "Is the Balanced Budget Amendment Politics at Its Worst?" Levy teamed with Hinchey and William Curry, a former counselor to President Clinton, to argue yes; du Pont, Blackwell, and Niskanen opposed them.

Is the Balanced Budget Amendment a Recipe for Disaster?"

Du Pont, Blackwell, and Niskanen argued that the balanced budget amendment was not a recipe for a future disaster, but was a remedy for a disaster that has already occurred. For decades Congress has spent above its means, leaving future generations of Americans to pay the tab, they argued. Blackwell likened the deficit to a large dog taking food from American children: "The

opponents of this amendment say it is enough if we just say, 'Stop, you bad dog! Stop, you naughty deficit!' I would suggest that the recipe for disaster is failing to put a muzzle, a constitutional muzzle, on the large dog so that it will stop eating the lunches that we pack for our children."

Levy, Hinchey, and Moynihan countered that the real disaster could occur in our future if the federal government lacks the means to prevent an economic decline. A balanced budget amendment, they argued, would limit the government's ability to use fiscal policy to stabilize the economy. According to Moynihan, it is the current unrestrained fiscal policy that has resulted in a half-century of economic prosperity: "We've had 50 years of steady growth, incredible wealth," with only "four quarters of actual negative decline in all that time."

Hinchey said, "The most important lesson, perhaps, that we learned from the Great Depression is the idea that stimulation by the government . . . is one way to bring the country out of a deep depression, out of recession, and to get the economy moving again."

If the economy slows down and government revenues decrease, Congress will be forced to cut spending under a balanced budget amendment. This action could turn an economic slowdown into a recession, Levy argued. Government should increase spending during a slowdown to prevent a recession, not cut spending.

Levy warned that a balanced budget amendment could have repercussions we do not yet understand. "The balanced budget amendment is the Jurassic Park of policy prescriptions. Like the movie entrepreneur who thought he could clone dinosaurs and keep them under control in a zoo theme park, the proponents of the balanced budget amendment are dealing with issues that are far more complex, far-reaching, and dangerous than they recognize. If we pass this amendment, we will have more and longer recessions. We will have increased threats to our financial system. We will, within about 30 years, have to completely scrap our monetary system. We will undermine the president's constitutional powers as commander-in-chief. We will lock in a terrible accounting system that assures neglect of infrastructure, major defense programs, modernization of government, and so forth. The list goes on and on."

This scenario was viewed as unlikely by du Pont, Blackwell, and Niskanen. The balanced budget amendment allows Congress to use deficit spending when necessary to deal with economic crises, they argued. It does not take away the fiscal powers of Congress; it merely makes it more difficult for Congress to engage in deficit spending by requiring a three-fifths vote in both houses to "unbalance" the budget. "[The amendment] doesn't require that the Congress do nothing about a stimulative policy if it thinks that's the correct policy. It doesn't require the Congress to vote anything up or down. It just makes it a little more difficult for the Congress to spend money," du Pont said.

"It is important to make deficits the exception, not the rule, in our fiscal policy-to allow deficits during a recession, during a major war, during a major capital building program, but to make

balanced budgets the rule, not the exception. And that is what this amendment will do," asserted Niskanen.

It is the "supermajority" vote that concerned Levy, Hinchey, and Moynihan. Such a requirement, they argued, would allow a minority of representatives or senators to block deficit spending, thereby undermining the concept of majority rule. There is another important problem with the three-fifths requirement, Levy argued. Nations rarely recognize they are on the road to an economic slump until they are well on their way. By the time three-fifths of the members of both houses recognize there is a problem and action must be taken, it might be too late.

"If you want to expect a supermajority in each house of Congress to recognize this and override the debt ceiling, just keep in mind that even Alan Greenspan, the esteemed chairman of the Fed and a distinguished forecaster of his time, five months into the last recession, according to Fed minutes, said not only that we weren't in a recession, but he saw no danger of recession," Levy said.

"Is the Balanced Budget Amendment Politics at Its Worst?"

Responding no to this question, du Pont, Blackwell, and Niskanen argued the balanced budget amendment will force Congress to act responsibly. Unrestrained spending has allowed members of Congress to use spending for political gain. The amendment will end this practice and force Congress to tackle the budget issue, they argued.

"Going back to 1908, The New York Times wrote in an editorial concerning the adoption of the income tax that when men get in the habit of helping themselves to the property of others, it's hard to cure them of it. I would suggest that the past 35 years of deficit spending by the Congress of the United States has been a question of helping themselves in the Congress to the property of the next generation of Americans," du Pont said.

In Blackwell's view, a balanced budget amendment was not politics at its worst, but rather politics at its best. A balanced budget would force politicians to end "the games that they've been playing for 35 years, mortgaging the future of our children and grandchildren."

Levy, Hinchey, and Curry countered that a balanced budget amendment would merely provide Congress with an excuse to avoid budget issues. "It's stunning to me that we are presently considering a balanced budget amendment, given the extraordinary experience of the last two years, first watching the United States Congress fail to muster a bare majority to enact a budget and choose in fact to shut down the federal government rather than transact the nation's business," Curry said. "What we've entered into, I think, is an era of politics by gesture and symbol."

Hinchey argued, "[The amendment] substitutes illusion for substance, and it allows the

Congress to pretend that it's in favor of balancing the budget by passing an amendment to the Constitution and not really doing anything to bring about a balanced budget. Balancing the budget is hard work." He continued that it could be years before 38 states ratify a balanced budget proposal, providing Congress with the excuse to avoid budget issues while waiting for passage of the amendment. Without the amendment, Congress is forced to take immediate action to deal with the budget deficit.

While agreeing with Hinchey that Congress must face the tough task of tackling budget issues, Niskanen said a balanced budget amendment at least sets up the rules by which Congress must play, and that in itself will help end the current political budget games: "The president, the members of Congress, all have to play by the rules."

Du Pont, Blackwell, and Niskanen expressed the concern that deficit spending has become imbedded in American culture and threatens the well-being of future generations of Americans. "I would suggest to you that over the last 35 years, we have seen a cultural shift from a country that was based on hard work and saving and progress and opportunity to a debtor nation and debtor households. And I would suggest to you that the elected representatives of the people have a responsibility to in fact turn that cultural shift back in a more positive direction to mend the foundation of this country that has been cracked," Blackwell said.

Curry responded that the argument that deficit spending is detrimental to the well-being of current and future generations of Americans might seem plausible, but one must also consider the benefits accrued from past deficit spending. Many of the expenditure programs that have contributed to the budget deficit, such as Medicare and Social Security, have done much to redistribute wealth. "There has been a massive redistribution of wealth in this country through the government in the second half of this century. It's going principally to the elderly."

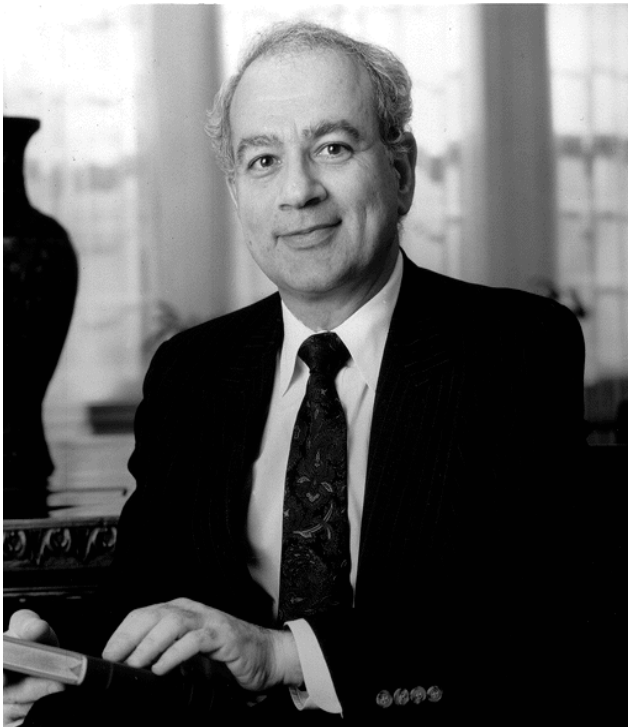
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Editorial

Balanced Budget Amendment Is Good Rhetoric, Bad Policy

by Dimitri B. Papadimitriou

Commentary reprinted from the *Chicago Tribune*, January 31, 1997



Executive Director Dimitri B. Papadimitriou

Once again Congress is taking up the issue of a balanced budget amendment to the Constitution. Legislators have voted on similar amendments five times since 1982 and each time the amendment has gone down in defeat. And for good reason. While the arguments in favor of the amendment strike many appealing chords, they simply do not add up to good economic policy.

Proponents of a balanced budget amendment argue that the national debt resulting from deficit spending is an abomination that dampens economic activity and crowds out private investment. They cite a need to restore "fiscal responsibility" to an out-of-control Congress, arguing that a constitutional amendment is the only way to force legislators to make difficult budgetary decisions. In addition, proponents claim that the federal government's deficit spending is unique among American governments, households, and businesses. They must all balance their budgets, the argument goes, so why not the federal government? Topping off the list is the moral argument: Is it right to expect future generations of Americans to pay for the spending of the current generation?

None of these arguments withstands objective scrutiny. Research by the late economist Hyman Minsky, for example, found that a lack of government debt could lead to the collapse of the U.S. banking and monetary system. In the case of the savings and loan debacle of the 1980s, the financial structure was protected only because government was able to go into debt to assure that the liabilities of our depository institutions would not go below full value. Safe, secure

government debt is an important asset that stabilizes our financial system and overall economy. In addition, research by the Levy Institute, among others, has cast doubt on the often-cited theory that government debt substantially crowds out private sector borrowing.

The argument that American households and businesses must balance their budgets simply does not hold true. Debt is a vital instrument for financing investment and capital development in the private sector. Businesses incur debt to fund expansion and train new employees and so do all American households that buy a car or a home or take out a college loan. Were it not for the ability to take on debt, many businesses would never expand or take creative risks, and many Americans would be unable to obtain an education that provides new opportunity for increased wages or to gain entrepreneurial skills to start new businesses.

The argument that state and local governments must balance their budgets is also not entirely accurate. State and local governments do run deficits, but they have found creative ways to hide them. They have capital budgets for financing long-term investments outside of their operating budgets, for example. The federal government has no capital budget, so all federal expenditures, whether consumed entirely in the year they are purchased or over several years, are recorded in the same way.

Former New York State comptroller Edward V. Regan has cited several gimmicks used by states to "balance" their budgets: accelerating revenues, such as tax collections, while delaying payments; shifting the financing of government functions to off-budget accounts; borrowing repeatedly against the same assets; selling assets under lease-back schemes; deferring maintenance and infrastructure costs; and reducing pension contributions. Rather than promoting fiscal responsibility, a balanced budget amendment is more likely to encourage new levels of fiscal irresponsibility as the federal government adopts similar schemes in search of apparent balance.

And what about the moral argument that through deficit spending we are running up a huge national debt that will bankrupt our children's future? One could just as easily argue that through deficit spending we are laying the foundations for our children's future economic prosperity. It was past deficit spending that pulled the nation through depression, war, and natural disasters and that built the post-World War II economic prosperity we are now enjoying. Is it not equally important that our children inherit a society that affords them job opportunities, quality schools, a clean environment, safe streets, and a rising standard of living?

History has shown that there are times when deficit spending is necessary to lift the economy out of recession or to overcome a natural disaster. While the balanced budget amendment would allow Congress to "unbalance" the budget in time of need, doing so would require a three-fifths vote of both the House and Senate. This is hardly in keeping with our beloved principle of majority rule. The will of the majority could be undermined by 40 senators or two-fifths of House members. If one thinks back to the difficulty of achieving a simple majority in last year's budget debate, which featured a government shutdown and market-rattling threats of default, the

likelihood of mustering three-fifths support in both chambers, even in times of national crisis, seems slim.

Just how dangerous is deficit spending? The current federal budget deficit is 1.4 percent of GDP-far less than in many other industrialized nations and far below what it was 40 to 50 years ago. In the late 1940s and early 1950s, the nation undertook a broad public investment initiative that caused the debt-to-GDP ratio to balloon to 129 percent. Not only did this investment lay the cornerstone for stable economic growth and prosperity for the next half century, the debt-to-GDP ratio was reduced to its current low level within that time.

The potential damage to the U.S. economy-and therefore to the well-being of Americans-from a balanced budget amendment to the Constitution could be far greater than the perceived dangers of deficit spending. If we truly believe our government is fiscally irresponsible, we must not delude ourselves into believing that a constitutionally forced balanced budget will solve this problem. A far better solution would be to educate the public about the true relationships among federal spending, economic stability, and investment in the future. Given the facts, the public will force its elected representatives toward the only real answer: End wasteful, unproductive spending.

The views expressed in this editorial are the author's and do not necessarily reflect the opinions of the Board of Governors, the Board of Advisors, or the research staff of The Jerome Levy Economics Institute.

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New Working Papers

Protracted Frictional Unemployment as a Heavy Cost of Technical Progress

William J. Baumol and Edward N. Wolff

Working Paper No. 179

Rapid technological change results in longer unemployment for those who lose their jobs, Research Associates William J. Baumol and Edward N. Wolff find. They present evidence that there is some substance to workers' fears that technological progress can threaten jobs. They have found that as labor-saving innovations and new production techniques are put in place, jobs are eliminated and duration of unemployment increases. Workers lose jobs when their skills do not match advancing technology.

Although the unemployment rate has remained relatively stable over recent decades, workers who lose a job remain out of work for longer periods of time and some never become employed again. The duration of unemployment has doubled since the mid 1950s, with an especially rapid increase since the 1970s.

All demographic groups have suffered from declining wages or protracted and possibly lifetime unemployment, but some classes of workers are affected more than others because of the relative cost to employers of retraining them 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 hardest hit as employers calculate the return on their investment in training. It costs more for employers to retrain less-educated workers than to retrain more-educated workers. Since employers feel that older men are likely to be with the firm less time than younger men, they are more willing to invest in training younger workers. And, because employers assume that women of childbearing age are more likely to quit than male workers, they feel their money is better spent in retraining men.

Research has shown that long periods of unemployment impose social as well as economic costs. The social costs include divorce, mental illness, suicide, domestic violence, and more. Clearly, the increase in protracted unemployment has serious consequences for American society.

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New Working Papers

The Utilization of Human Capital in the United States, 1975-1992: Patterns of Work and Earnings among Working-Age Males

Robert Haveman, Lawrence Buron, and Andrew Bershader

Working Paper No. 180

The experience that comes with age and the productive capacity of youth are both assets widely underused in the American labor market, according to Research Associate Robert Haveman and co-authors Lawrence Buron and Andrew Bershader of the University of Wisconsin. To measure the use of American labor, the authors developed an indicator called the capacity utilization rate (CUR). Using male workers for their study, they first determined the earning capacity of males based on such characteristics as basic ability, schooling, skills, work experience, and health status. The earning capacity was then compared with actual earnings to arrive at the CUR. If earning capacity is greater than actual earnings, male labor capacity is underused.

The authors found that not only is male labor underused, but this underutilization is increasing, especially among low-skill groups such as minority males who have dropped out of school. Also in decline is the labor utilization of older males. For older males the underutilization is often voluntary—the result of early retirement. For younger males the underutilization is more closely related to exogenous constraints. The inability to find work and personal factors such as illness and family responsibilities discourage many from seeking work. Others voluntarily decide to work only part-time.

These declines in labor utilization should be of concern to policymakers. Underutilization of older workers is occurring at the same time that many policymakers think working lives ought to be extended. More worrisome is the underutilization of youth because the nation's production in future years will depend on their labor.

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New Working Papers

Which Immigrant Occupational Skills? Explanations of Jewish Economic Mobility in the United States and New Evidence, 1910-1920

Joel Perlmann

Working Paper No. 181

Researchers have long sought explanations for the success of Jews who migrated to the United States at the turn of the century in attaining middle-class status. East European Jews arrived in the United States at the same time as many other ethnic groups between 1880 and 1920, yet achieved economic success far faster. In the search for an explanation, Senior Scholar Joel Perlmann draws on data from the 1910 and 1920 U.S. Censuses, which allow for comparison among ethnic groups. Data on Russian Jewish immigrants were gathered by selecting those who were Russian-born and gave Yiddish as their mother tongue

One explanation offered for Jewish mobility is that the skills of Jewish immigrants matched the needs and opportunities in the American economy at the time they immigrated. The skills acquired in Russia as artisans and craftsmen (the industrial skills) enabled them to fit easily into the American economy, both as employed workers and as self-employed business owners. However,

Perlmann finds in the data that a large percentage of English and Scottish immigrants also reported having such experience in skilled manual work, yet these groups were not as

successful. Perlmann suggests that explanations to account for this difference need to be examined. For example, one explanation is that Jews came not only with industrial skills, but also with commercial skills acquired through occupational experience in trade. Another explanation that has been offered involves a cultural pattern of assigning higher status to certain kinds of work, but the intertwining of values and skills makes this concept difficult to analyze.

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New Working Papers

Literacy among the Jews of Russia in 1897: A Reanalysis of the Census Data

Joel Perlmann

Working Paper No. 182

Researchers exploring Jewish literacy have traditionally ignored the Russian Census of 1897 on the grounds that it underreported Jewish literacy. Most have felt that the low literacy percentage reported for Jews could not possibly be accurate and therefore scholars have ignored the value of the Census as a research tool. In a study that compares the results of the 1897 Census with the 1926 Soviet Census, Senior Scholar Joel Perlmann concludes that the 1897 Census is more accurate than past scholars have acknowledged.

Perlmann notes that the 1897 Census first asked Jewish males if they were literate in Russian. Those who answered yes were not then asked if they were literate in another language. Adding the percentage reporting literacy in Russian to the percentage reporting literacy in another language—most likely Yiddish—gives the total percentage of Jewish males who were literate. This figure is 54 percent for those over 60 and 72 percent for those between 20 and 29.

As a test of the accuracy of the 1897 data, Perlmann compared it to the 1926 Soviet Census. Those who were in the 20-29 age group in the 1897 Census were, for the most part, in the 50-59 group in the 1926 Census; those in the 30-39 group in 1897 were in the 60-69 category in 1926; and so on. Matching the literacy rate of each age group in the 1897 Census with the rate of the corresponding group in the 1926 Census, Perlman found that the rates are similar. This is especially so if allowance is made for some increase in literacy through learning later in life and for some decrease in literacy due to aging. On the basis of the consistency between the two sets of data, Perlmann concludes that if the 1926 Census was accurate, then Jewish literacy was probably not underreported in the 1897 Census, as so many researchers have believed.

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New Working Papers

Corporate Governance and Corporate Employment: Is Prosperity Sustainable in the United States?

William Lazonick and Mary O'Sullivan

Working Paper No. 183

Unless American corporations change their structure of governance, it is unlikely that many will remain prosperous in this age of global competition, argue William Lazonick and Mary O'Sullivan, both at the Center for Industrial Competitiveness at the University of Massachusetts. U.S. companies are not being hurt by low-wage competition, but by their failure to invest in the organizational learning required to remain competitive. U.S. corporate managers have become increasingly concerned with providing returns to stockholders, while their foreign competitors, especially the Japanese, invest in innovative thinking in order to provide higher-quality products at lower prices. American corporations have fallen behind because stockholders have gained control over corporate decision making. Also, since management pay is often tied to stock options, management has additional incentive to make stock pay off.

In recent decades much corporate stock has come under the ownership of pension and mutual funds. Thus, more American households have a stake in stock values. And most of those households would rather get an immediate return on their investment than have their holdings reinvested for future returns. The ability of these stockholders to influence U.S. corporate decision makers has been aided by the tendency for the managers to be isolated at the top of the corporate hierarchy. Many U.S. managers are "generalists" who may have skills in management but lack specialized knowledge of their corporation's products. They are therefore less familiar with the production processes and problems of their corporations than are many of their foreign counterparts. This isolation at the top has left U.S. corporate managers more susceptible to pressure from stockholders looking for quick returns.

In order for U.S. corporations to remain competitive, the corporate governance system must be revised. Corporations must invest in organizational learning-the acquisition by members of the corporation of the knowledge to solve problems collectively. The goal of all should be improving the business as a whole.

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New Working Papers

The New Welfare: How Can It Be Improved?

Oren M. Levin-Waldman

Working Paper No. 184

If policymakers are serious about overhauling the welfare system, argues Resident Scholar Oren M. Levin-Waldman, they must stop making a distinction between being on welfare and being unemployed. They must get rid of the welfare department and get rid of the unemployment insurance office and create one employment office.

Those who have long received welfare benefits and those who have recently lost a job should be served by the same government agency. Changing to such a system would end the stigma associated with welfare and shift the policy focus to where it ought to be—to helping all those who need work, find work.

The 1996 welfare legislation, known as the Personal Responsibility Act, does not make much of a change in the welfare system. It ends AFDC as an entitlement program and replaces it with federal block grants; therefore, federal funding of AFDC is no longer guaranteed, but is subject to the annual appropriation process in Congress. Supporters of the change claim that it allows states greater flexibility in their welfare programs and that such flexibility will make it easier for states to experiment with different types of programs. But, Levin-Waldman points out, waivers granted under the former welfare legislation did the same thing. Indeed, several states, most notably Massachusetts, Minnesota, and Wisconsin, had already acquired waivers and were experimenting with different forms of welfare programs.

If federal and state governments really want to "end welfare as we know it," they must make a commitment to helping welfare recipients find work. Recipients should be viewed as unemployed who need help finding meaningful work. And the greatest emphasis should be placed on training.

A major roadblock to merging welfare and employment programs is cost. Programs truly committed to moving welfare recipients toward work are not inexpensive, as can be seen from Wisconsin's experience. Successful employment programs are likely to cost more than simply providing welfare, but they would yield long-term benefits.

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