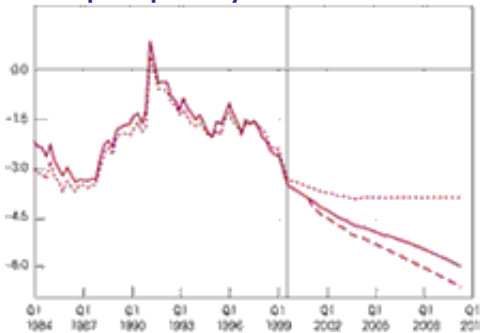

Report**March 2000***Volume 10, Number 1*

Wynne Godley analyzes trends in the recent past and prospects for the trade deficit, debt, and property income



James K. Galbraith on moving toward sustained full employment without inflation

The most serious danger for sustained full employment does not lie in external developments or inherent weakness, but in interest rate raises by the Federal Reserve and a commitment to surpluses by the administration.

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

S Jay Levy, *Chairman*
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Editorial

Full Employment and How to Keep It

James K. Galbraith, Senior Scholar

The American economy today enjoys near-full employment, declining pay inequality, and stable prices. There is therefore a surplus in the budget. As the good news continues, the so-called crisis of the Social Security system recedes into the future, like the mirage it always was.

Credit for these developments will accrue to President Clinton. This is right and proper. The final judgment on a president's economic policy should rest on economic outcomes: "Are you better off?" And yet, whether Clinton's policies are sustainable or whether changes are needed to keep the expansion going is the most important economic question facing the country today.

The question requires an open mind. Morbid premonitions are no less dangerous than blind overconfidence. The present-day economy is healthy and apparently immune to certain scourges that so frightened some economists in the recent past. Fear of full employment is one such phobia. Three or four years ago most professional economists scoffed at the possibility of full employment without inflation. To allow the unemployment rate to drop below 6 percent, we were confidently told, would produce not just higher but accelerating inflation—a drift toward disaster. But inflation did not accelerate when unemployment slipped below 6 percent four years ago. It did not accelerate when unemployment fell below 5 percent in 1997 or even when it breached 4.5 percent sixteen months ago. Last month, the interim targets of the Humphrey-Hawkins Full Employment Act—unemployment at 4.0 percent with inflation below 3.0 percent—were achieved exactly. And inflation shows no sign of accelerating now.

The global environment also seems less threatening than it did last year. The Asian crisis continues and falling exports to that region continue to cost manufacturing jobs, but a few quick cuts of the interest rate in the fall of 1998 proved sufficient to ward off financial panic and the U.S. expansion continued, trade deficits and all.

Then there are worries about financial instability—a "Great Crash" ending to the expansion. This cannot be ruled out; no economist since Irving Fisher (who said, in the summer of 1929, that "stocks have reached a permanently high plateau") feels entirely secure about the future of an asset boom. Today, certain price-earnings ratios are indeed very high; the valuation of Internet companies is preposterous; and the blue chips have been sinking every day. But spontaneous financial collapse, as in 1929 to 1932, still seems remote. Nor are we all that vulnerable to a

flight of hot money, as happened in Asia in 1997. Where in the world economy would hot money fly to?

These considerations suggest that the most serious dangers ahead lie not in external developments or in inherent weaknesses but in policies themselves: the monetary policy of the Federal Reserve presents an immediate risk and the fiscal policy of the administration a more remote but still definite one. Monetary policy is the clearest present danger. Interest rates are rising. A coalition of obsolete theorists (monetarists and natural-raters) has formed inside the Federal Reserve alongside those who always favor higher interest rates on behalf of bankers and bondholders. The Fed raised interest rates three times last year and seems set to keep on raising them until economic growth stalls out and unemployment starts to rise.

The interest rate was once-a century ago-a major theme of progressive politics. But since the New Deal, progressives have been slow to take it up again. Yet the power of low and stable interest rates to generate prosperity in the American economy is truly vast; we owe our current full employment to Alan Greenspan's exceptional willingness, since 1995, to keep his powder dry. Equally vast is the power of sharply increasing interest rates to disrupt and destroy. This is particularly true because prosperity breeds debt-household debt ratios are reaching historic highs-and debt breeds vulnerability to rising interest rates.

The future of fiscal policy is written into law. Given realization of a cautious set of underlying economic projections-real growth at just 2.4 percent per annum-budget analysts now project vast excesses of tax revenue over public spending, sufficient if sustained nearly to eliminate the public debt within 20 years. How likely is this actually to happen? One bit of evidence comes from looking at the incidence of fiscal surpluses since 1945. In every case (except one, during the Korean War), a budget surplus was followed by a slump, with falling real GDP, rising unemployment, and a return to deficit spending. As a matter of history, the achievement of a sustained budget surplus is unheard of.

Why is this so? The old Keynesian answer is fiscal drag: the fact that excess taxation and inadequate public spending deplete private incomes and slow private consumption and investment. This simple phenomenon of yesterday's textbooks has not disappeared. It has merely been forgotten, suppressed by the mass amnesia concerning basic Keynesian principles that seems to afflict the economics profession. To believe that the world is now different, that we are in a "new age" of sustainable surpluses, one needs reasons. None come to mind, and the prudent inference from this lack of reasons is surely that the expansion will not be sustained. An eventual slump-produced if not by fiscal drag alone then by the combined effects of rising surpluses and rising interest rates-is likely. One may reasonably ask how, with policy changes, can a slump be delayed.

Two answers seem clear. First, one might set out to regain control of the Fed. Fiscal drag can be offset, perhaps for quite some time, by steadily lower interest rates and a deepening willingness of private households to borrow and spend. Right now, though, the rate raisers are in command.

Nothing can stop them except, perhaps, strong political protest aimed at the structure of decision making on these issues. The president has two vacancies on the Fed board to fill (one nomination is stalled at the moment), and Congress could strip the banker-dominated regional presidents of their Open Market Committee vote. There is no reason why the making of monetary policy should be a permanent fiefdom for bankers, bondholders, and right-wing economists (including two holdovers from Ronald Reagan's Council of Economic Advisers, of all things).

Wouldn't lower interest rates fuel the stock bubble? Actually, it is rising interest rates that have this effect because as the rates rise, speculators reallocate resources to riskier investments. But if the stock market is a real worry, the Federal Reserve could take the appropriate action of raising margin requirements to reduce stock purchases with borrowed money. And Congress could pass a transactions tax that would curtail day trading and other casino approaches to the stock market.

A second answer to the question of how policy might delay a slump is that one might calibrate fiscal policy so that a sharp tightening does not actually occur. This might be prudent since it would place a bit more of the burden on the financially solid public sector and a bit less on families and businesses in the private sector. But how could it be done? The Republicans are ready with a program that reflects their sure nose for what the clients like: tax cuts on capital gains and high incomes. But this won't work. Cutting taxes on the highest incomes and on estates will not spur consumption or employment; these steps simply channel idle funds back into the stock and other financial markets. (The Federal Reserve's reaction to this inflow and resulting higher prices-higher interest rates-seems sure.) Capital gains tax cuts, on the other hand, could precipitate a stock market rush to the exits.

Rather than stoke the financial fancies of the very rich, it would be more sensible to expand public sector services for all. We still need affordable housing, parks, theaters, libraries, schools and universities, streets, communications lines, and environmental protection, not to mention a comprehensive health care system. In public sector services, though, there is a practical difficulty: the necessary time frame is quite long. Public spending should grow with sustained prosperity, but slowly, allowing time for strong management and political support to develop. Given the late start on this project (itself due to the obsession with surpluses), fiscal drag could begin to bite before any rescue from increased public spending gets under way.

A bridging strategy is therefore required. It should support the income of low-wage working people and their access to credit and to housing, increasing private consumption by those who most need a better living. A higher minimum wage should be passed this year and so should an expanded earned income tax credit. A third step would be a cut-perhaps expiring after five years-in the Social Security payroll tax. Probably no other measure would do as much to strengthen employment while actually cutting labor costs. But to consider cutting the payroll tax requires us to rethink the Social Security financing problem. And that brings us into another domain of taboos and illusions.

Is there really a financial problem with Social Security? What does the "trust fund faces depletion" mean? Should we care? Or has the myth (for that is what it is) of a trust fund, once the political pillar of Social Security, now become a weakness in thinking about it? Suppose the Social Security Trust Fund did not exist. In that case, projections from this moment forward would not be concerned at all with whether the fund is "solvent." Rather, the pertinent question would be whether the federal government as a whole was in position to meet its financial obligations, including Social Security payments, for the indefinite future. Since the fiscal projections for the budget as a whole are (at present) for surpluses indefinitely, this is not in doubt. Social Security, along with every other government program, is perfectly sound and affordable. And even if there are no surpluses, there would be no Social Security "crisis" or any possibility of one, as long as the federal government remains within the limits of its capacity to borrow. During the worst years of the Reagan deficits, no one spoke of a "Pentagon financial crisis." The Social Security "financing problem" exists because of the trust fund and for no other reason. It is a phony issue. Abolish the trust fund, and it would go away.

One cannot doubt the tactical brilliance of the Clinton-Rubin solution to the Social Security crisis: Dedicate the projected overall budget surpluses to the trust fund. This means that a large capital sum will be added to the fictitious entity, entitling it to a large flow of future interest payments, thus staving off the dire moment when "depletion" occurs. The plan reassures the public and strikes fear into the privatizers, the means-testers, the benefit cutters, the CPI chiselers, and the retirement age raisers. If things work out, Social Security benefits might well be saved, for the most part, by this ingeniously dishonest device.

The question is, What does a commitment to surpluses mean to the economy? Does it mean a return to slumps? And if the economy turns down and the projected surpluses regarded with reverence by Clinton and Rubin (and now Larry Summers) do not materialize, will the perception of a Social Security crisis return, more virulent than before? It is true that President Clinton's strategy of slow-but-steady growth has paid off in the long run. Those of us who argued for a rapid growth strategy back in 1993 (the two-track program) have to acknowledge this. We could not have gotten the collaboration of the Federal Reserve-the subduction of Alan Greenspan by Keynesian tectonics-that Clinton's approach actually and at long last achieved.

But there are dangers in long periods of success. They lead to a belief that the one true way has been found. After the political trauma of the Reagan-Bush budget deficits, surpluses have come to be seen as endowed with magical power to protect us. Al Gore has actually said that if a recession brought the deficits back, he would raise taxes to keep the budget balanced. There is even fanciful talk about eliminating the national debt. That would be a financial disaster. But the chances of its occurring are essentially nil; fiscal drag and rising interest rates will sink the economy and the surpluses long before.

The way forward-toward sustained full employment without inflation-lies in a judicious expansion of public services and public investments with expanded support and reduced taxes for low- and moderate-income families, combined with stable interest rates alongside higher

margin requirements and transfer taxes to dampen speculation. Good economics and progressive politics have converged. Now the task is to prevent bad economists and right-wing politicians from obstructing that way forward.

James K. Galbraith is a professor at the Lyndon B. Johnson School of Public Affairs and the Department of Economics at the University of Texas at Austin. He is the author of *Created Unequal: The Crisis in American Pay and the forthcoming Inequality and Industrial Change: A Global View*. This essay is adapted from a review of the *Economic Report of the President* for 1999 published in *Challenge*, November-December 1999.

Strategic Analysis

Interim Report: Notes on the U.S. Trade and Balance of Payments Deficits

Wynne Godley

<http://www.levy.org/docs/sreport/stratan.html>

This is Distinguished Scholar Wynne Godley's summary of a report in his series of strategic analyses based on projections derived from his accounting-based models of the U.S. and world economies. He presented these findings in December to the Trade Deficit Review Commission, a bipartisan congressional panel charged with studying ways to narrow the U.S. trade deficit.

1. The United States has a balance of payments deficit worth nearly 4 percent of GDP and negative net foreign assets (or foreign debt) worth nearly 20 percent of GDP. If U.S. growth is sustained in the medium term, it is quite likely that the balance of trade in goods and services will not improve. The United States is the only major country, or country "bloc," to have a substantial trade deficit and this is proving of great advantage to the rest of the world.
2. If the balance of trade does not improve, there is a danger that over a period of time the United States will find itself in a "debt trap," with an accelerating deterioration both in its net foreign asset position and in its overall current balance of payments (as net income paid abroad starts to explode). Such a trap would call imperatively for corrective action if it is not at some stage to unravel chaotically.
3. The emergence of a debt trap is put forward as a possibility that must be taken seriously rather than as a forecast of what is most likely to happen. Policymakers are advised to ensure that adequate instruments are available should things start getting out of hand.

4. Whether the outflow of property income starts to accelerate depends critically on the rate of return earned on internationally owned assets and liabilities. The well-known condition for exploding payments on debt is that the rate of interest exceeds the growth rate. At present the United States's negative position is worth about \$1,500 billion while the net foreign income outflow is only about \$10 billion, so it might be supposed that there is nothing to worry about. But this is deceptive. The low rate of return overall, measured ex post, is the consequence of the extremely low return so far earned on foreign direct investments in the United States. However, the bulk of any change in the net asset position, in the future as in the past, is likely to take the form of financial investment, which has been earning a much higher rate of return and one that, even now, slightly exceeds the growth rate. Also, the return on foreign direct investment may improve.
5. There have recently been extremely heavy direct investments by foreign firms in the United States but a high proportion of these have been financed by exchange of shares and, to that extent, make no contribution at all to the financing of the deficit. The analysis of capital account flows and rates of return would be greatly facilitated if acquisitions financed by share exchange were identified separately in the accounts.
6. Policy responses in principle come down to (a) reducing domestic demand, (b) raising foreign demand, (c) reducing imports and increasing exports relative to GDP, preferably by changing relative prices.
7. The danger is that resort (perhaps by default) will be had to remedy (a), in other words, that chronic and growing imbalances between the United States and the rest of the world come to impart a deflationary bias to the entire system, with harmful implications for activity and unemployment. Remedy (b) reads hollow when neither appropriate institutions nor agreed upon principles exist, but should not be dismissed out of hand. As for remedy (c), currency depreciation is the classic remedy. But, in view of the way global capital markets work, depreciation has ceased to be a policy instrument in any ordinary sense, and "floating" cannot be counted on to do the trick. Policymakers should be aware of the possibility of using nonselective (nondiscriminatory) control of imports in extremis in accordance with the principles set out in Article 12 of the WTO. Such a policy is to be sharply distinguished from "protectionism" as commonly understood.

New Public Policy Briefs

A New Approach to Tax-Exempt Bonds

Edward V. Regan

[Public Policy Brief No. 58](#)

State and local governments rely heavily on tax-exempt bonds to finance infrastructure projects from transportation systems to sports stadiums. These bonds are a subsidy from the federal

government in that they allow the municipal governments to pay out a lower rate of interest than they would have to in the taxable bond market. Purchasers of these bonds are willing to accept a lower interest rate because interest payments are exempt from federal taxes. Without this tax-exempt bond market, state and local governments would have to borrow in the regular market, where interest rates are 15 to 20 percent higher.

Edward V. Regan, a Levy Institute policy advisor and chairman of the Municipal Assistance Corporation for New York City, argues that there is a better way to finance state and local government investment. He points to three main problems with the current system. First, the borrowing costs of municipal governments are not reduced by the full amount of the loss to federal revenues; instead, there is transfer of wealth to high-tax bracket investors. Second, large pools of capital are excluded as sources of infrastructure investment because tax regulations regarding exemption have limited the participation in the tax-exempt market of large institutional and foreign investors and pension funds have never participated. Third, the tax-exempt market is not subject to the oversight that large institutional investors and other participants impose on the regular markets.

Regan presents an alternative method for financing state and local government investment, based on a new security concept, the American global infrastructure security (AGIS). The AGIS has two components—tax exemption and income flow—which are sold separately. Decoupling the components makes municipal bonds marketable to two groups of investors (those who seek tax shelter and those who seek yield). It reduces the effective interest rate for the issuer, opens the market to more groups of investors, and imposes the oversight inherent in the regular bond market.

Note: Public Policy Brief No. 59, Financing Long-Term Care, by Walter M. Cadette, is based on his Working Paper No. 283, which was summarized in the November issue of the Report.

A Dual Mandate for the Federal Reserve

Willem Thorbecke

[Public Policy Brief No. 60](#)

The Federal Reserve currently has two legislated goals—price stability and full employment—and it has been pursuing both. However, Congress is engaged in a continuing debate about whether the Federal Reserve should assign primacy to fighting inflation in formulating monetary policy. The assumptions underlying the argument for price stability as the "primary and overriding goal" are monetary policy cannot affect real variables, it cannot be used to moderate short-run economic fluctuations because it has an inflationary bias, even moderate inflation inhibits economic growth, and inflation targeting provides the nominal target that monetary policy needs.

Research Associate Willem Thorbecke, of George Mason University, presents evidence from

the recent history of monetary policy and economic performance to rebut all four assumptions. He then presents several reasons for the equal importance of full employment as a goal. First, under the current dual mandate the United States has experienced low unemployment and low inflation, while many countries whose central banks target inflation are experiencing double-digit unemployment. Second, the costs of unemployment to individuals and the economy as a whole are known to be substantial, but the costs of moderate inflation are probably not large. Third, central bankers tend to be inflation-averse and, if anything, need to be prodded to take goals other than inflation into account. Fourth, if the Fed pursues only price stability, the price level is not free to increase; such an increase may be necessary to avoid large increases in unemployment following an adverse supply shock.

According to Thorbecke, the current monetary policy regime has had excellent macroeconomic results. The dual mandate has allowed the Fed to focus on inflation or unemployment as conditions demand and to balance the effects of policy decisions. Shifting from an approach that has been so successful to a single goal of price stability, which has not proved successful in other economies, seems unwise.

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New Working Papers

The Distribution of Wages: A Non-parametric Decomposition

Conchita D'Ambrosio

[Working Paper No. 284](#)

The distribution of welfare has long been a matter of concern in economics, and the best methods to measure this distribution and to make comparisons among different societies have long been matters of debate. Conchita D'Ambrosio, of Boconi University in Milan and New York University, presents a new procedure to analyze the effects of different factors on observed changes in any distribution.

The advantage of D'Ambrosio's method is that it provides a means of identifying factors that have an impact and determining where on the distribution they do so. It also offers a new method of distinguishing between-group from within-group components. She applies the method to the distribution of wages in Italy, providing measures of observed movement, polarization indexes, measures of distance and divergence among distributions in different geographical areas, and considers such factors as industrial development and composition, unemployment rate, age of population, and number of working family members.

Computers and the Wage Structure

Michael J. Handel

[Working Paper No. 285](#)

A leading explanation for the rapid growth in U.S. wage inequality in the last 20 years, consistent with both human capital and postindustrial theories, is that advances in technology increase job skill requirements, and thus the demand for high-skilled labor, and reduce the demand for less-skilled workers. Resident Scholar Michael J. Handel finds little evidence to support this explanation.

Using previously unavailable data, Handel finds an upward bias in measured returns to computer use in Alan B. Krueger's 1993 study, which showed a wage premium associated with computer use. He also finds that most of the growth of inequality since 1979 occurred in the early 1980s, which is inconsistent with a primary role for computers. Finally, computer use at work had equalizing impacts on the gender wage gap and elsewhere in the wage distribution as well as disequalizing impacts on the wage gaps between education groups. When the contribution of computer use to all components of the variance of wages is taken into account, computers seem to have had a net equalizing impact in the period Krueger studied. This casts significant doubt on this technology-based explanation of the growth in wage inequality.

The History of Wage Inequality in America, 1820 to 1970

Robert A. Margo

[Working Paper No. 286](#)

According to Robert A. Margo, of Vanderbilt University and the National Bureau of Economic Research, most analyses of the increase in wage inequality in the United States in recent decades fail to place the change in historical context. Margo's study of the wage structure from 1820 to 1970 provides that context.

Margo finds compelling historical evidence that the expansion of educational opportunity has been a long-term potent force in narrowing wage differentials. A rise in returns to educated labor began before the Civil War, continued until the end of the nineteenth century, and was followed by a decline over the 1900 to 1940 period. In the 1940s there was substantial further erosion in wage differentials, primarily as a consequence of government policies and increases in the relative demand for less-skilled labor associated with World War II. Although wage inequality today is high by post-World War II standards, it is not particularly high when measured against the pre-World War II condition.

Functional Finance: What, Why, and How?

Stephanie Bell

[Working Paper No. 287](#)

Stephanie Bell, of the University of Missouri-Kansas City, refutes frequent objections to Abba

Lerner's theory of functional finance, in which he held that government should use its fiscal powers to maintain prosperity. His first law makes the government responsible for keeping total spending at the level necessary to purchase all the output a fully employed labor force can produce. His second law is that in most cases printing money is the best way to finance deficit spending, and the only case in which government should sell interest-bearing debt is when private spending would otherwise generate excessive aggregate demand. Using T-account balance sheet entries, Bell demonstrates the applicability of Lerner's principles as a guide for fiscal and monetary policy.

Is There a Wage Payoff to Innovative Work Practices?

Michael J. Handel and Maury Gittleman

[Working Paper No. 288](#)

During the 1980s wage inequality increased dramatically and the American economy lost many high-wage, low- to medium-skill jobs that had provided middle-class incomes to less-skilled workers. Increasingly, less-skilled workers were restricted to low-wage jobs that lacked union or other institutional protections. A number of sociologists, economists, and industrial relations scholars assert that, although "good" jobs for less-skilled workers are unlikely to return in their previous form, a system of work practices now being adopted in many workplaces may lead to higher productivity, better firm competitiveness, and ultimately higher employee wages. This system, often called "high performance," involves workplace reorganization to create more skilled and interesting jobs and greater employee involvement in organizational decision making.

Resident Scholar Michael J. Handel and Maury Gittleman, of the OECD and the U.S. Bureau of Labor Statistics, examine the link between the high performance model and employee wages by using data from a nationally representative sample of businesses and their workers containing information on management practices and workers' wages and background characteristics. They find little evidence that high performance work practices are associated with higher wages.

New Perspectives on the Guaranteed Income

Karl Widerquist

[Working Paper No. 289](#)

The idea of a guaranteed income to ensure an adequate standard of living for all has been around in the United States in one form or another since Thomas Paine proposed it in 1796, but it has not been a significant part of the public debate. Recently, however, interest in a guaranteed income has been growing, as is evident from the number of books that have been published on the topic in the 1990s.

Resident Research Associate Karl Widerquist reviews seven of those books: *Arguing for Basic Income: Ethical Foundations for a Radical Reform*, edited by Philippe Van Parijs; *Real*

Freedom for All: What (If Anything) Can Justify Capitalism? by Philippe Van Parijs; *Public Economics in Action: The Basic Income/Flat Tax Proposal*, by Anthony Atkinson; *The \$30,000 Solution*, by Robert R. Schutz; *The Benefit of Another's Pains: Parasitism, Scarcity, Basic Income*, by Gijs Van Donselaar; ". . . And Economic Justice for All": *Welfare Reform for the 21st Century*, by Michael L. Murray; and *The National Tax Rebate: A New America with Less Government*, by Leonard M. Greene.

Finance in a Classical and Harrodian Cyclical Growth Model

Jamee K. Moudud

[Working Paper No. 290](#)

Resident Scholar Jamee K. Moudud expands on work presented in his earlier working paper, "Finance and the Macroeconomic Process in a Classical Growth and Cycles Model" (No. 237), which produced a model based on a variant of a social accounting matrix (SAM) with endogenous bank credit. The basic goal of this model is to study the effects of exogenous demand injections (for example, from a budget deficit) within a growth context. This was central to Sir Roy Harrod's seminal work on cyclical growth. Harrod's model, however, was unstable. Building on Anwar Shaikh's solution to Harrod's instability problem, the current model investigates two stable growth cycles, one of which is the disequilibrium dynamics between aggregate demand and supply (which is essentially the "business cycle," in common parlance) and the other the disequilibrium dynamics between actual and normal (desired) capacity utilization. Bank credit and debt dynamics are fundamental to the business cycle dynamics.

This paper contains three innovations. First, it treats inventory investment explicitly. Second, it splits the SAM into a current and a capital account, thereby making it easier to derive the balance sheet counterpart of the flow matrix. Third, it discusses the stability properties of the differential equation system that underpins the model; it can be shown formally that business debt provides the anchor that stabilizes the model's business cycles.

The Social Wage, Welfare Policy, and the Phases of Capital Accumulation

Jamee K. Moudud and Ajit Zacharias

[Working Paper No. 291](#)

The future of the welfare state has become one of the most contentious issues in public policy. Most OECD countries have rolled back their welfare policies in the belief that they have acted as a drag on economic activity. Resident Scholar Jamee K. Moudud and Resident Research Associate Ajit Zacharias address two broad questions: the economic rationale for the existence of the welfare state and the macroeconomic impacts of welfare spending.

Moudud and Zacharias review the marginalist arguments for the existence of the welfare state and counterpose a historical and institutional analysis of the rise of the U.S. welfare state. They

examine the standard neoclassical macroeconomic arguments for and against welfare cutbacks and then propose an alternative growth framework, rooted in the classical and Harrodian traditions, to evaluate social policy. They argue that the alternative framework provides both demand-side and supply-side mechanisms whereby social spending can be supported without harmful long-run macroeconomic effects. Their analysis suggests that there may not necessarily be tension between social policy and economic performance and that recent cutbacks in social programs in the United States are hard to justify on purely economic grounds.

Why Do Political Action Committees Give Money to Candidates? Campaign Contributions, Policy Choices, and Election Outcomes

Christopher Magee

[Working Paper No. 292](#)

According to Christopher Magee, of the Department of Economics at Bard College, political action committees (PACs) make campaign contributions to influence actions of winning candidates once they are in office and to affect the outcome of elections. Magee examined the effect of contributions on the outcomes of the 1996 elections to the U.S. House of Representatives and used a *Congressional Quarterly* survey to determine the impact of contributions on representatives' policy positions.

Magee suggests that when political action committees donate campaign funds to challengers, they are attempting to affect the outcome of the election by increasing the challengers' chances of winning. These contributions may have an impact on the election, but they do not seem to affect the challengers' policy stances. In contrast, campaign contributions to incumbents do not raise their chances of being reelected. They seem to be given in the hope of gaining influence or to secure services that elected officials can provide, such as influencing the legislative agenda, even if the policy stance is not affected.

Employment Inequalities

Andrew Glyn and Wiemer Salverda

[Working Paper No. 293](#)

The deteriorating economic position of less-skilled workers in OECD countries has not only contributed directly to rising economic inequality, but has also compounded the difficulties faced by workers who are already at a disadvantage in the labor market for reasons of age, gender, or race. Many economists argue that wage flexibility can increase employment for these workers. Andrew Glyn, of Corpus Christi College of Oxford University, and Wiemer Salverda, of the University of Groningen, document the employment disadvantage faced by the less-qualified segment of the labor force and examine the factors that influence the differing extent of this disadvantage across OECD countries.

Glyn and Salverda adopt as their measure of employment disadvantage the difference between the employment rates for quartiles of the population ranked by educational qualification. They show that differences between the rates for the most- and least-educated quartiles vary substantially within Europe, but the employment disadvantages are not on average higher than those in the United States, even though wage differentials are higher in the United States. The least qualified suffer the greatest employment disadvantage in countries in which the overall employment rates are low and, for men, in which the literacy test scores for the least qualified are relatively low. A high level of imports from low-wage countries appears to be associated with greater employment disadvantage, but there is no discernible tendency for a high level of wage dispersion, low benefits, or weak employment protection legislation to be associated with greater employment disadvantage. Glyn and Salverda's central conclusion is that labor market flexibility, encouraged by low minimum wages, low benefits, and weak employment protection and reflected in high-wage dispersion, has not been the route by which some OECD countries have managed to minimize the employment disadvantage of the least qualified. Countries with centralized bargaining systems have fared better and any impact of deregulation appears to have been marginal compared to the influence of the overall demand for labor.

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New Policy Note

Social Security Privatization: A Bad Idea

Walter M. Cadette

[Policy Note 1999/10](#)

Concern that the Social Security system will face financial difficulty as the baby boom generation enters retirement has resulted in proposals for reforming the system, several of which call for partial or total privatization of the system. Senior Scholar Walter M. Cadette argues that privatization in any form is bad policy because it would undermine the redistributive mechanism that has been at the heart of Social Security since its inception.

The privatization plans propose setting aside part of workers' Social Security taxes in private accounts and allowing workers to invest in assets of their own choosing. The assumption is that the investments would generate higher returns than the Social Security system currently earns on its reserves. Cadette points out that there are many disadvantages to private management. Returns to investment are not guaranteed. Some workers may make bad decisions, a risk that many low-income workers cannot afford, and it is unlikely that the high average long-term return on securities will continue. Also, the shift to a privatized system will involve transition costs. Cadette argues that the way to deal with the impending financing problem is not through privatization but through long-run macroeconomic policy. The solution is to raise the economy's growth potential and to draw down its foreign and domestic debt.

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Levy Institute News

Lecture

Michael North: Institutional Factors in the Economy of Early Modern Germany

According to Michael North, of Ernst Moritz Arndt University, the study of economic history in the United States and the United Kingdom has been greatly influenced by the new institutional approach since the 1960s, when institutions and institutional change began to be seen as a driving force. Historical studies of the German economy, however, have barely been affected. North attempts to rectify this by examining the economic effects of institutions in early modern Germany.

North defines institutions as "humanly devised constraints that shape human interaction." They can be formal (such as laws and contracts) or informal (such as cultural norms). The significance of formal institutional structure in early modern Germany has been underestimated largely because the Holy Roman Empire was not a modern nation state but a confederation of self-governing states. But, imperial institutions contributed to the development of a market economy in Germany.

The supreme courts-the Imperial Chamber Court and the Imperial Council-were among the most important institutions for economic development and growth. To determine the courts' role, North examined every documented case that was brought before the Imperial Chamber Court from Hamburg, Lübeck, Mecklenburg, Schleswig-Holstein, and Pomerania between 1495 and 1806. He found that economic matters constituted by far the majority of cases from Lübeck and Hamburg. The economic cases were a smaller share of the cases from the more agrarian Mecklenburg, but that share was still significant. Decisions such as those enforcing contracts and settling guild disputes created a culture of confidence in market participation and production, which was decisive for the expansion of trade. The imperial jurisdiction was closely connected with economic activity and was a major institutional factor in development of a market economy.

North noted three areas in which the institutional approach can make a valuable contribution to the study of economic history. First, there should be a reevaluation of the role of the state in the economy because it was the state that largely initiated institutional change up until the beginning of the nineteenth century, when that role was taken over by the subjects. Second, there should be discourse between economics and law, especially between economic history and the history of law, which can establish a link between constitutional history and the causes of economic

growth. Third, there should be discourse between economic history and social and cultural studies to increase understanding of effects of informal institutions on economic behavior.

Upcoming Events

The Liberalization of Financial Markets: National and International Perspectives

Tenth Annual Hyman P. Minsky Conference on Financial Structure
April 27-28, 2000

Liberalization of international capital flows is hailed by some analysts as the means by which emerging nations can be drawn into the globalized financial market, but others warn that if those nations make the leap into modern capitalism without first establishing a sound regulatory and institutional framework, they are embarking on a path that can lead to national and ultimately international disaster.

As part of its research program on financial markets and monetary policy, the Levy Institute is organizing this conference to explore the ramifications of financial liberalization by considering questions such as:

- What is the current status of international and domestic financial markets?
- What is the likelihood of upheaval in financial markets?
- What effect will recent policy decisions by international agencies and national governments have on the stability of these markets?
- What is the current status of electronic banking and what impact will it have on the financial system?
- Is a new international regulatory and institutional framework needed to create a system that can withstand shocks without deteriorating into crisis? If so, what form might or should it take?
- What have been the successes and failures of monetary integration in Europe?
- What are the pros and cons for Latin American economies of dollarization?

Among the participants at the conference will be:

Robert Z. Aliber, University of Chicago

Robert Barbera, Hoenig & Co.

Philip F. Bartholomew, Committee on Banking, U.S. House of Representatives

Stijn Claessens, World Bank

The Honorable Barney Frank (D-Mass.), U.S. House of Representatives

Timothy F. Geithner, Undersecretary for International Affairs, U.S. Department of the Treasury

Wynne Godley, Levy Institute

Henry Kaufman, Henry Kaufman & Company

Jan Kregel, UNCTAD; Levy Institute

David A. Levy, Forecasting Center, Levy Institute
Martin Mayer, Brookings Institution
Ernest Patrikis, American International Group
Ronnie J. Phillips, Colorado State University
H. Onno Ruding, Vice President, Citibank
Kenneth I. Thomas, Wharton School of Business
Frank Veneroso, Veneroso Associates
Nancy A. Wentzler, Office of the Comptroller of the Currency
Byron R. Wien, Morgan Stanley Dean Witter & Co.
L. Randall Wray, University of Missouri-Kansas City; Levy Institute

The conference will be held at Blithewood. See our web site for [program](#) and registration information.

Workshop: Earnings inequality

June 6, 2000

Blithewood

(By invitation only)

Conference: Saving, Intergenerational Transfers, and the Distribution of Wealth

June 7-9, 2000

Blithewood

(Conference fee: \$150)

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Publications and Presentations

Publications and Presentations by Levy Institute Scholars

Distinguished Scholar Wynne Godley

Presentations: "Notes on the U.S. Trade and Balance of Payments Deficits," Testimony before the Trade Deficit Review Commission, Washington, D.C., December 10, 1999; "Credit and Money in a Keynesian Model," University of Ottawa, December 17, 1999; "Why the U.S. Boom Is Unsustainable," Allied Social Sciences Association, Boston January 7-9, 2000.

Visiting Senior Scholar Philip Arestis

Publications: "Globalization, Regionalism and National Economic Policies" (with E. Paliginis), in J. Toporowski (ed.), *Political Economy and the New Capitalism: Essays in Honour of Sam*

Aaronovitch (Elgar, 1999); "Financial Liberalisation: The Experience of Developing Countries" (with P. Demetriades), Working Paper no. 19, Department of Economics, University of East London, November 1999; "Financial Crisis in South East Asia: Dispelling Illusion the Minskyan Way" (with M. Glickman), Working Paper no. 22, Department of Economics, University of East London, December 1999; "Financial Liberalisation in Developing Countries" (with P. Demetriades), *Eastern Economic Journal*, Fall 1999.
Presentations: "The Relevance of Kalecki's 'Political Aspects of Full Employment' to the 21st Century" (with F. E. Skuse) and "The Economics of New Labour: An Assessment of the First Two and a Half Years" (with M. Sawyer), Allied Social Sciences Association, Boston, January 7-9, 2000.

Senior Scholar James K. Galbraith

Publications: "Inequality and Unemployment in Europe: The American Cure" (with Pedro Conceição and Pedro Ferreira), *New Left Review*, no. 10, 1999; "Inequality in American Manufacturing Wages, 1920-1998: A Revised Estimate" (with Vidal Garza-Cantú), *Journal of Economic Issues*, September 1999; "The American Wage Structure, 1920-1947" (with Thomas Ferguson), *Research in Economic History* 19 (1999); Review of *Boggs: A Comedy of Values* by Lawrence Weschler, in *The American Prospect*, December 6, 1999; Review of *The Economic Report of the President, Challenge*, November-December 1999; Review of *Money and the Nation State: The Financial Revolution, Government and the World Monetary System*, Kevin Dowd and Richard H. Timberlake Jr. (eds.), *Journal of Economic History*, December 1999; "How the Economists Got It Wrong," *The American Prospect*, February 14, 2000.
Presentation: Testimony before the Trade Deficit Review Commission, Washington, D.C., December 10, 1999.

President Dimitri B. Papadimitriou

Presentation: "Unfinished Agenda for Full Employment Policy," New York University, November 23, 1999.

Senior Scholar Joel Perlmann

Publications: "Multiracials, Racial Classification, and American Intermarriage," in Werner Sollors (ed.), *Interracialism* (Oxford University Press, 2000); "Are the Children of Today's Immigrants Making It?" (with Roger Waldinger), in Stephen Steinberg (ed.), *Race and Ethnicity in the United States* (Blackwell, 2000).

Visiting Senior Scholar Malcolm Sawyer

Publication: Editor, *The Legacy of Michal Kalecki*, vols. 1, 2 (Elgar, 1999).

Senior Scholar Edward N. Wolff

Publications: "The Economy and Philanthropy," in Charles T. Clotfelter and Thomas Ehrlich (eds.), *Philanthropy and the Nonprofit Sector in a Changing America* (Indiana University Press, 1999); "Specialization and Productivity Performance in Low-, Medium-, and High-Tech

Manufacturing Industries," in Alan Heston and Robert E. Lipsey (eds.), *International and Interarea Comparisons of Income, Output, and Prices, Studies of Income and Wealth*, vol. 61 (Chicago University Press, 1999); "Recent Trends in the Distribution of Household Wealth," in Ray Marshall (ed.), *Back to Shared Prosperity?* (M.E. Sharpe, 2000).

Presentations: "Will Stocks Save the Middle Class?" Japan External Trade Organization, New York, October 12, 1999; "Recent Trends in Wealth Inequality," Georgetown Law School, Washington, D.C., January 5, 2000; "Why Stocks Won't Save the Middle Class," American Association of Law Schools, Washington, D.C., January 6-7, 2000; "Has Canada Specialized in the Wrong Manufacturing Industries?" CSLS Conference: The Canada-U.S. Manufacturing Productivity Gap, Ottawa, January 21-22, 2000.

Media: Commentary on Donald Trump's proposal for a wealth tax, CNN Nightly News, December 15, 1999; "The O'Reilly Factor," Fox Cable News, January 18, 2000; Commentary on inequality in the United States, ECON News (Japan), February 4, 2000.

Visiting Senior Scholar L. Randall Wray

Publications: "The 1966 Financial Crisis: Financial Instability or Political Economy?" *Review of Political Economy*, no. 4 (1999); "Money, Credit and Finance" and "Monetary Theory of Production" (with Johan Deprez), in Phillip O'Hara (ed.), *Encyclopedia of Political Economy* (Routledge, 1999); "Subway Tokens and Social Security," *Center for Full Employment and Price Stability*, Policy Note 99/2 and Dismal.com, September 1999.

Presentations: "Buckaroos: The Community Service Program at UMKC," Second Annual Path to Full Employment, University of Newcastle, Australia, December 1-2, 1999; "Can Penal Keynesianism Replace Military Keynesianism?" Allied Social Sciences Association, Boston, January 7-9, 2000.

Media: Interview, community public radio, Kansas City, December 1999.

Research Associate Mathew Forstater

Publications: "Vision and Analysis in Heilbroner's Political Economy: Worldly Philosophy and the Nature and Logic of Capitalism," *Journal of Economic Issues*, December 1999; "Savings-Recycling Public Employment: Vickrey's Assets-Based Approach to Full Employment and Price Stability," in A. Warner, M. Forstater, and S. Rosen (eds.), *Commitment to Full Employment* (M.E. Sharpe, 2000); editor (with A. Warner and S. Rosen), *Commitment to Full Employment* (M.E. Sharpe, 2000).

Presentations: "Working Backwards: Instrumental Analysis as a Policy Discovery Procedure," New York University, November 1999; "Full Employment and Discrimination," Allied Social Sciences Association, Boston, January 7-9, 2000; "Must Spontaneous Order Be Unintended?" Conference: Science as a Spontaneous Order, Copenhagen, January 2000.

Resident Scholar Oren M. Levin-Waldman

Publication: "Minimum Wage and Justice," *Review of Social Economy*, March 2000.

Resident Scholar Jamee K. Moudud

Publication: "Economic Growth," in *International Encyclopaedia of Political Economy* (Routledge, 2000).

Presentation: "Open Economy Macrodynamics," Allied Social Sciences Association, Boston, January 7-9, 2000.

Resident Research Associate Ajit Zacharias

Presentation: "Wassily Leontief and Mainstream Economics," Allied Social Sciences Association, Boston, January 7-9, 2000.

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