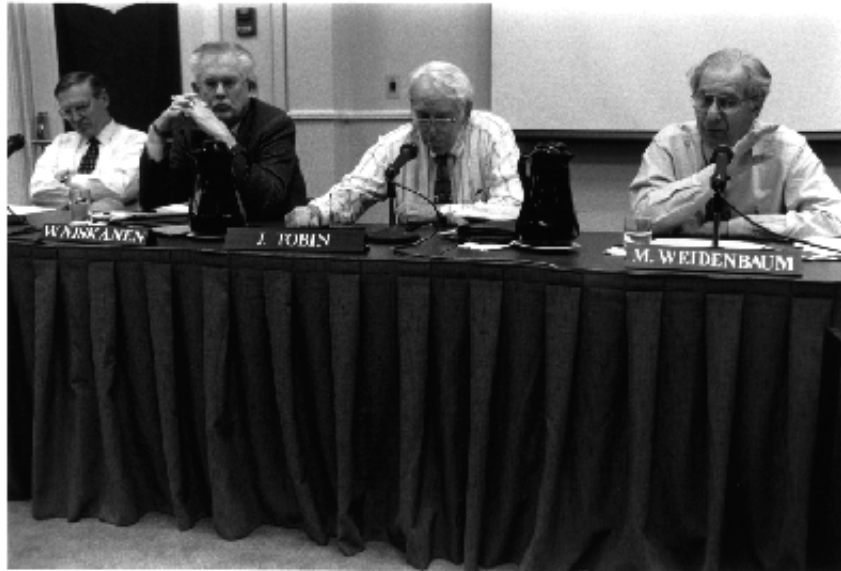

Report

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Participants in the annual employment conference's session "The Employment Act of 1946: A Perspective from the Council of Economic Advisers": George C. Eads, council member under President Carter; William Niskanen, member under President Reagan; James Tobin, member under President Kennedy; Murray Weidenbaum, chairman under President Reagan

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- At the Levy Institute conference marking the 50th anniversary of the Employment Act of 1946, Alicia H. Munnell of the Council of Economic Advisers reports that 68 percent of the increase in jobs between 1994 and 1996 pay wages higher than the median wage (see page 3).
- Speaking at the Levy Institute's sixth annual conference on the financial structure, Federal Reserve Governor Janet L. Yellen expresses concern that financial innovation has complicated regulating traditional measures of financial soundness (see page 7).
- At the same conference, J. P. Morgan & Co. Vice Chairman Roberto G. Mendoza prophesies that only three of the current four or five global and purely wholesale banks

will survive (see page 7).

- In the Report interview, J. Kenneth Blackwell, treasurer of the State of Ohio, recommends that municipalities be prohibited from investing in derivatives (see page 15).
- In two new working papers, Levy Institute Distinguished Scholar Hyman P. Minsky and Visiting Scholar Charles J. Whalen show how the new "money manager" capitalism has increased economic uncertainty and forced the development of new institutional arrangements to deal with this uncertainty

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

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Annual Conference on Employment

On April 25 and 26 the Levy Institute held its annual conference on employment issues, "The Employment Act of 1946: 50 Years Later." The conference focused on the status of the goals stated and institutions established in the 1946 act. Featured speakers were Katharine Abraham, commissioner of the Bureau of Labor Statistics; George Becker, president of the United Steelworkers of America; Richard E. Cavanagh, president of the Conference Board, Inc.; S Jay Levy, chairman of the Levy Institute; and Alicia H. Munnell, member of the Council of Economic Advisers. Conference sessions were entitled "The Links Among Technological Change, Corporate Restructuring, and Stable Employment," "The Economic and Labor Market Effects of Immigration," "Options for Low Inflation and Long-Term Employment," "Marketplace Dynamics and Less-Skilled/Low-Wage Workers," "The Employment Act of

1946: A Perspective from the Council of Economic Advisers," and "Employment Policy in a Changing Marketplace." The speakers' remarks are summarized below.

Katharine Abraham

Katharine Abraham's address, "The State of Our Economic Intelligence: Where We've Been and Where We're Going," focused on the evolution of economic data collection since the Employment Act of 1946. She noted that although the act made no mention of the statistical agencies of the federal government, it is clear that sound economic data are critical to the role that the act envisioned for those charged with the development and execution of macroeconomic policy. A surprising amount of information was available prior to the passage of the act, including data on employer payrolls and employment, average weekly hours and earnings, labor force participation and unemployment, wholesale and consumer prices, and gross national product. At that time, however, there was no model for how data would be collected. Initially, Bureau of Labor Statistics (BLS) reports were perceived as advocacy pieces rather than objective analyses. In order to counteract this perception, the BLS and other data-collecting institutions adopted professional standards, and the practice of objective analysis they established continues to today.

Since 1946 improvements in the production of core economic measures have been made by sharpening concepts, expanding the scope of coverage, announcing all publication dates in advance, and limiting access to data prior to their release. Abraham noted that there is a natural tension between wanting to improve the data and wanting to keep measurements constant in order to have a consistent series. Most improvements were suggested by expert panels, such as the 1962 Gordon committee, the 1979 Levitan commission (on employment data), the 1961 Stigler committee, and the current Boskin commission (on consumer prices). These panels were convened in response to perceptions that there were serious problems with certain data. For example, the Boskin commission stemmed from congressional testimony about the consumer price index (CPI) by Alan Greenspan in which he stated that research at the Fed indicated that there was a significant (1.0 to 1.5 percentage point) upward bias in the measure. Since a more slowly rising CPI would slow the growth of federal spending, increase the flow of tax revenues, and reduce the federal budget deficit, it is not surprising that in the current climate of austerity this issue has received a lot of attention.

Abraham judged that economic data are substantially better today than in 1946 and that, contrary to some news analyses, "our statistical system is second to none in the world." She offered three possible explanations for why the data are perceived as unreliable. First, demands are now placed on the data that were not envisioned when the data were designed; these demands result from the "pocketbook implications" of the data, such as their effects on stock market prices, federal spending levels, and federal tax brackets. We should remember, noted Abraham, that these data were designed as economic indicators to be used for description and analysis, not necessarily for the purposes for which they are used today. Second, the data do not

cover aspects of economic questions that have arisen since the data were designed. For example, employment statistics were designed at a time when most people worked full-time and on site. The present diversity of employment arrangements leaves some questions unanswerable with the available data. Third, budgetary constraints prevent the BLS from producing much data beyond what it is legally required to produce. In real terms the BLS appropriation is the same now as it was in 1978.

George Becker

George Becker prefaced his remarks saying that for him work and economics are a real-life experience. As a noneconomist he may not always understand all of the economic models presented to him, but he does know, based on his experience, what works and what does not and what is good for workers and the United States.

During the period from 1979 to the early 1990s the federal government encouraged imports and, through its antiinflation policies, "gave away" an estimated 9 to 11 million American jobs in industries such as steel, auto, electronics, textiles, and shoes. The steel industry was virtually dismantled and the steelworker's union lost over a half a million members. The jobs lost were "family-supportive jobs," that is, jobs that had allowed workers to make enough money to participate in the American dream: to raise a family, buy a house and a car, and educate their children. The communities in which these jobs were lost have not recovered: water systems were shut down, schools and hospitals were closed, and police and fire services were curtailed.

During this time the steelworker's union worked with the surviving mills, forcing some companies to stay open and becoming experts in newly devised plans to keep companies afloat, such as employee stock ownership plans (ESOPs) and concession bargaining. In concession bargaining the union insisted that companies reinvest in the mills at the first opportunity. In many cases the union took over the mills and instituted new work practices. Many mills reached partnership agreements with the union. The surviving U.S. steel industry is the most competitive in the world.

The world of work, however, changed forever. Family-supportive jobs were eliminated and new ones have not been created. The incomes of two working spouses do not equal the income from one family-supportive job during the 1970s. It is the exception when a young worker can get a job with health care benefits, and job security is not even a dream for most. In spite of soaring U.S. productivity levels, living standards are declining.

What went wrong with the so-called American dream? Becker vehemently disagreed with those who assert that no one has any idea of what is causing wage stagnation or how to raise wages. Quite the contrary, we learned what is necessary from the Great Depression: Workers need to be allowed to organize, to bargain collectively with their employers, and to share in the wealth they create. During the last 20 years, however, employers have rejected this contract and have made every effort, at times in collusion with the government, to negate it.

Becker stated that government policy should be directed toward encouraging and assisting in the creation of family-supportive jobs. It is his belief that Federal Reserve policies are a part of the problem, not a solution. Controlling inflation by raising interest rates generates a tremendous transfer of wealth from working people to Wall Street and causes economic stagnation. The 5.5 percent of workers who are unemployed as a result are prohibited from participating in the American Dream. Becker asserted that any system that requires a large reservoir of unemployed people to keep wage rates and the economy depressed in order to be successful is fundamentally flawed.

Richard E. Cavanagh

Richard E. Cavanagh asserted that articles published in the popular and academic presses often lead to the impression that large-scale enterprise accounts for an increasingly smaller percentage of total employment, that downsizing among large firms is the principle factor in total job loss, and that downsizing has been undertaken to satisfy the interests of Wall Street. It is easy to understand how the fact that the ten largest companies that announced downsizing since 1993 displaced a total of 279,000 workers might lead to such a conclusion, but, according to Cavanagh, that impression is inaccurate. He examined data from a recent issue of Fortune magazine on the 390 firms among the 500 largest industrial and service corporations headquartered in the United States in business today that also were in the Fortune 500 in 1991. (Among the remaining 110 corporations, some had merged, such as CBS and Westinghouse; some had split into separate entities, such as Sears Roebuck; and others had possibly changed their name.) He found that employment among the 390 totaled about 20 million workers in 1995, or 17 percent of total U.S. employment, a figure consistent with past employment shares (17.0 percent in 1960, 17.6 percent in 1980, and 17.4 percent in 1990). These same firms created 500,000 net new jobs since 1991, a figure representing about 5 percent of the total employment increase during the period. Cavanagh reasoned that the employment and job creation figures imply that these firms are neither the principal destroyers of jobs nor the principal creators of new jobs. In addition, Cavanagh observed that some firms (61 percent) experienced rapid (greater than 10 percent) employment growth, while others (26 percent) experienced employment declines.

Cavanagh also found that the 13,000 companies publicly traded on a stock exchange (including the Fortune 500) accounted for approximately 45 million jobs. Their job growth was characterized by Cavanagh as modest and stable. During the past three years the number of publicly held firms increased by 8,000 from a base of 5,000 in 1993, so there is no comparative data for 1991 and 1995 for about two-thirds of the current firms. However, the 4,600 firms for which there is common data for 1991 and 1995 accounted for 1.2 million new jobs, or 12 percent of U.S. job growth for the period.

Cavanagh asserted that employment growth among these firms was driven by revenue growth, profitability, and return to shareholders. Of the top 25 firms in revenue growth, 16 were among the top 25 in terms of employment growth, and, surprisingly, 30 of the 53 industry groupings

grew in employment, including textiles, apparel, and food, which all posted greater-than-average employment growth. Among the 390 Fortune 500 firms, those companies having high (over 20 percent) returns to shareholders over the past 10 years also had high (7 percent) employment growth; those experiencing declines in shareholder returns (averaging 10 percent or more decline) posted a 9 percent decrease in employment. Moreover, firms that had declining returns to investment cut employment, while those that posted a high return to investment share increased employment.

Cavanagh observed that the performance of individual companies was more important than the sector in which a company did business. For example, some of the largest employment increases were experienced by high-technology firms (Microsoft, Dell, Compaq, and Quantum), but some of the largest employment losses were posted by firms in the same industry (DEC, Wang, and IBM). Employment growth was also recorded in some of the so-called mature industries, in which we would not expect such growth to occur (State Farm Insurance, up 38 percent; Nike, up 27 percent; Mattel, up 19 percent); these firms also registered large gains in revenues and profits.

Cavanagh concluded that employment trends are likely to change somewhat in the near future and that some firms will experience tightening in their labor markets. Conference Board polls indicate that (1) in contrast to only three years ago, big business in the United States "is increasingly focused on the top line of revenue growth rather than the bottom line of return to shareholders"; (2) most people believe that downsizing and restructuring will continue, but that their limits have more or less been reached; and (3) the chief human resource officers from 50 of the 100 largest corporations in the United States predicted that within 12 to 18 months we will experience labor scarcity, particularly in high-quality, high-skill jobs. Cavanagh noted that a third of Conference Board members report that they currently have shortages in entry-level and senior-level technical and managerial personnel.

S Jay Levy

S Jay Levy discussed his concern that job insecurity, as distinct from unemployment, is rapidly spreading and intensifying. Levy, recalling the recent chess match between world champion Gary Kasparov and the IBM computer, Deep Blue, noted that computers now appear to have analytic capabilities that put many administrative and technical jobs at risk, jobs never before threatened by scientific advances. Technological change may also partly explain why formerly paternalistic corporations at the leading edge of applied technology, firms noted for employee security and good benefits, have in many ways turned their backs on their workers.

Levy voiced little doubt in the ability of the U.S. economy to create full employment at a level not truncated or guided by concepts such as a "natural" or nonaccelerating inflation rate of unemployment (NAIRU). If the nation maintained policies that stress growth and ignored a NAIRU, the U.S. economy would have full employment by almost any definition. However, the uneasiness arising from technological advances would hardly be alleviated by a boost in the rate of employment.

Technological advances will result in increased productivity in many industries, and labor costs will likely fall. Although greater use of computers and related machines will tend to limit price increases, something unique is happening today; technology is causing job losses that would occur regardless of policies that might result in cyclical unemployment. Skilled occupations are being displaced as a result of computerization. So although the economy is able to create a great many jobs, technology-driven displacement of well-paying jobs is occurring at an increasing rate.

Is technology no longer serving human beings? If so, what should we do? If technological advances are a major contributor to the present widespread sense of economic insecurity, we must address the ethical dilemma of whether we should embrace a system that puts masses of people in an uncomfortable, if not unhappy, condition. We cannot stop the march of technology, and it is one of gifts of the twentieth century. The trouble is that neither economic theory nor the wisdom developed by other disciplines has experience with the problems that arise from it.

Alicia H. Munnell



Alicia H. Munnell, member of the Council of Economic Advisers

Alicia H. Munnell spoke about macroeconomic issues related to the Employment Act and the recent report on the quality of new jobs issued by the Council of Economic Advisers (CEA). Munnell voiced her satisfaction that the Employment Act instructs "the federal government to use all practicable means to promote maximum employment, production, and purchasing power." The legislation represented a fundamental change in thinking about the magnitude of economic fluctuations we are willing to tolerate.

According to Munnell, the costs of allowing the economy to operate at less than maximum employment are significant. Even with unemployment insurance and income support programs, unemployment results in a loss of income, a reduction in future earnings potential, and devastating psychological effects. These consequences are particularly painful for the most disadvantaged members of society and aggravate existing trends of decreasing earnings and increasing income disparities. Although the situation of the poor and the low-skilled improved during the 1960s, it stagnated in the 1970s and worsened in the 1980s, especially during the 1980-81 recession. During the recovery of 1983 to 1989 the incidence of poverty remained high and earnings for families headed by people with less than a high school degree fell. Maximum

employment remains a necessary, although not sufficient, condition for improving the well-being of the disadvantaged.

Munnell noted that economic improvements during the past three years, especially improvements in the federal budget deficit, have allowed the economy to operate at full employment in an environment of low and stable inflation. The current unemployment rate is 5.6 percent as compared to 7.3 percent in 1993. Moreover, a recent CEA study reports that the quality of new jobs is good. According to BLS data, the percentage of the workforce with more than one job was 5.2 percent in 1970 and has since fluctuated between 4.0 percent and 6.2 percent; the figure stood at 5.8 percent in 1994 and 6.2 percent in 1995. These data imply that there has been no spurt in the number of people holding multiple jobs. In addition, the BLS household survey indicates that there has been no dramatic change in the percentage of people employed part-time, either involuntarily or voluntarily. Voluntary part-time employment has hovered around 14.0 percent and involuntary part-time employment around 3.5 percent.

In order to see whether new jobs are low paying and low skill, the CEA examined 1994 earnings data (the most recent data available for comparative purposes) across occupational and industry groupings. It extrapolated 1994 median weekly earnings (about \$480) according to 1996 occupational and industry groupings and found that 68 percent of the increase in employment consisted of jobs that paid wages above the median wage. (Munnell noted that the CEA could not be sure that the jobs that paid wages above the median in 1994 would necessarily pay wages above the median in 1996. However, she felt that the occupational definitions were narrow enough to provide useful information on this question.) Munnell contended that the CEA's findings, based on very detailed job classifications, showed that the number of low-skill and low-wage jobs declined in 1994 and 1995. Why then, hasn't wage growth improved? Munnell responded that "what happens to the people in the labor force is much more important in determining what happens to averages than the characteristics of the new jobs."

The CEA also examined possible explanations for growing economic anxiety. It attempted to determine if the probability of getting laid off had increased in recent years, but found that difficult to measure accurately. First, the most recent period for which BLS data on displaced workers are available is 1991 through 1993. Second, interpreting the difference in displacement rates between 1981-82 and 1991-92 is difficult even though the proportions of displaced workers in the workforce were roughly the same. For example, questions arose as to the appropriate method of correcting for differences in the business cycle, with each method yielding different conclusions about relative displacement. Two pieces of evidence, however, suggest that conditions have improved and displacement has declined. First, data on the number of people who have received unemployment benefits for five weeks (not on temporary layoff and seeking work) have followed the BLS data fairly well and suggest that the upcoming 1996 BLS survey on displaced workers could show some improvement. Second, some private (and somewhat controversial) surveys examining the number of announced layoffs also have suggested a

reduction in displacement levels.

Munnell hypothesized that if anxiety does not stem from a greater chance of being laid off, it could arise as a result of highly publicized announcements of large layoffs and the changing nature of the people experiencing job loss, namely, older, white-collar, and more educated workers who previously were not at risk. Other factors addressed in the CEA report-slow compensation growth, an increasing portion of total compensation paid as benefits, increased variability of wages-could contribute to rising anxiety.

How should the federal government respond to the problems associated with unemployment? Munnell noted the importance of three types of policies: encouraging basic education, training, and retraining; fostering benefit portability; and using the unemployment system to provide job search and counseling services to promote reemployment.

[The speakers' remarks and summaries of the session discussions are published in the conference proceedings. To request a copy, call 845-758-7700 or 202-737-5389 (in Washington, D.C.), fax 845-758-1149, e-mail info@levy.org, or write The Jerome Levy Economics Institute of Bard College, Blithewood, Annandale-on-Hudson, NY 12504-5000.]

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Sixth Annual Conference on the Financial Structure

On April 11 and 12 the Levy Institute held its sixth annual conference organized under the aegis of its ongoing research project on reconstituting the financial structure. Speakers featured at this conference, "Recent Developments in the Financial System," were J. Kenneth Blackwell, treasurer of the State of Ohio; Neil D. Levin, superintendent of the New York State Banking Department; Eugene A. Ludwig, Comptroller of the Currency; Roberto G. Mendoza, vice chairman and director of J. P. Morgan & Co., Inc.; Ernest T. Patrikis, first vice president of the Federal Reserve Bank of New York; Jay N. Woodworth, president of Woodworth Holdings, Ltd.; and Janet L. Yellen, member of the Board of Governors of the Federal Reserve System. Conference sessions were entitled "Assessing the Role of Derivatives and Controlling Their Risks," "Electronic Banking: Competing and Regulating in a Technological Age," "Bank Megamergers, Glass-Steagall Reform, and Competition in Commercial and Investment Banking," and "The Financial Sector and World Economic Development." Excerpts from the

speakers' remarks are presented below.

J. Kenneth Blackwell

"Public fund managers have replaced debt service with lip service. They preach caution but practice risk. Under pressure to increase revenues without raising taxes or cutting services, local treasurers try to make up the difference with aggressive investment earnings. Too many Main Street investors dive into the pool with Wall Street sharks. They or we are in way over our heads. . . . Derivatives are the financial equivalent of explosives on a construction site. Used properly they do the job like nothing else can, but used carelessly or by the wrong people, they blow up in your face."

"Derivatives are not inherently evil. Originally they were created to meet a specific objective-hedging risks. But public portfolios shouldn't hedge risks. Public portfolios should be risk averse. As public fund managers, we should adhere to three investment priorities: safety, liquidity, and yield, and precisely in that order. Safety is foremost; like the physician, the public fund investor must first do no harm. We collect tax money. We protect it. We invest it, but only because idle money means lost money. We cannot lose money. We cannot afford to go back to the taxpayers and say that we are going to tax you again for something that we have already taxed you for, or we are going to have to cut services that you have already paid for. If you have no risk or low risk, you have no need for derivatives."

". . . broker-dealers share responsibility when an issuer's investment strategy backfires. I suggest investment firms should sign statements declaring that they have read and understood an issuer's investment policy statement before doing business. . . . In the case of derivatives, brokers create and market a product. If they do not accept responsibility for their product, who will? The Ohio Treasury is the debt-issuing agent of the state. Our product is backed by the full faith and credit of the State of Ohio. The value of a 10-year bond is based on the economic well-being of the state, the confidence of its public fund managers, and the integrity of its elected officials. . . . If the bond fails, the buck stops with you-know-who. Where does it stop with a derivative? In whom does the investor trust? When the derivative strategy fails, where do you point? Who is held accountable?"

Neil D. Levin

"The [CRA], which was promulgated in 1977, moved the system away from one that was process based to one that is performance based, which is clearly in everybody's interest since it is supposedly much easier to measure. The concern at the [New York] State Banking Department is to ensure that we don't end up with the worst of both worlds, that is, requiring banks to achieve certain performance measures, but if they can't achieve them, they'd better record what went on in the process side so that they can then explain to the examiners why, in

fact, they haven't achieved a certain performance."

"I would also like to see if there's any chance of getting safe harbor included. My own belief is that the majority of banks are truly committed to serving their communities, whether they're idealistic or because it's good business. The problem is that most banks are rated satisfactory and don't try to achieve an outstanding rating because there is no reason from a business standpoint to spend the extra money to be outstanding. What I would like to do is provide some motivation, some positive incentive, for institutions to stretch to be rated outstanding. What I propose is creating a new, fifth rating called high satisfactory. This is not something that would safe harbor 97 percent of the institutions. An outstanding would be safe harbored immediately until its next examination, and two high satisfactories would be required before being granted a safe harbor."

"With regard to bank powers, congressional action does not appear to be imminent on Glass-Steagall reform. What can the states do while action does not occur in Washington? Although FDICIA limits the states' ability to grant new powers, there probably are some additional powers that the FDIC would approve. It is incumbent on the part of all states to ensure that their charters are as attractive and as competitive as possible. I would also make the prediction that if the states don't respond with regard to insurance, this will clearly be a factor in causing state-chartered institutions to rethink the state charter. There is absolutely no way that we are going to fool the banks into staying with a state charter if what we present them is a cumbersome, burdensome, expensive regulatory system. My commitment to preserving the dual banking system has increased dramatically over time. In the dual banking system choice is maintained: we avoid a concentration of power into a single system. Whether you are a domestic institution or a foreign institution, you absolutely have a choice. Concentration is ultimately bad for capital formation in this country. Competition between the two systems is probably a very healthy feature with regard to the quality of the exams and supervision, fees, and overall efficiency."

"There were some interesting issues raised with regard to Daiwa Bank. First, did supervision keep pace with the growth, scope, and complexity of the operations of foreign branches and agencies in this country? Did we keep pace in terms of our own requirements for internal controllers, internal auditors, or external auditors? Another issue is the type of job do we all do [federal and state regulators] when we find a weakness in the course of an examination, but it doesn't rise to the level of requiring formal enforcement action."

"Just as domestically we talk about supervising state institutions in our multistate nation, we need to face up to the fact that we are now in a global environment and that cooperation and coordination among supervisors worldwide is essential. If there isn't adequate communication, there is no way the job can be done."

Eugene A. Ludwig

"As we move into the twentieth century, we are seeing that changes in the marketplace are

calling into question the assumptions on which the current framework is based. First is the notion that geography forms the appropriate basis for determining what rules apply to the offering of financial services and who applies those rules. Second is the idea that certain legitimate financial activities are in and of themselves simply too risky for financial institutions to engage in and that such a judgment can be responsibly made without regard to the strength or sophistication of either an institution's own risk management systems or the supervisory capacities of its regulator. Third is the related idea that without regard to the strength or sophistication of either a financial institution's own risk management systems or the supervisory capacities of its regulator, certain government-mandated organizational structures meaningfully address the risks of providing certain financial products and services."

"Compared to their predecessors of a generation ago, banks today have greater freedom to achieve geographic and product diversification, diversification that enhances their risk management strategies and competitive positions and also their strength and stability. But in the area of bank structure, the corporate form of banking organizations, the trend has been strangely backwards. As the ability of banking organizations to set their own mix of product and services has increased, their ability to decide upon the appropriate corporate structure for offering that mix has declined. I believe we are now overdue for a reexamination of the costs and supposed benefits of government-mandated corporate structures, because the progress we've realized in our quest to make banks more competitive will be set back if we continue to force banks into structures that serve no clear public policy purpose. Whatever their source, as the pace of competition continues to accelerate, these limitations are fast becoming a source of competitive inequity that is ultimately quite likely to have detrimental effects upon the safety and soundness of the banking industry."

"I believe three forces now at work in the marketplace will eventually require the government to place less emphasis on mandated corporate structure and greater emphasis on effective supervision. These forces are industry consolidation, the evolution of the bank charter, and competition from nondepository businesses. Statistics [about industry consolidation] tell a story of how government-imposed structure forces the industry in one direction and how the market, when allowed to do so, moves the industry toward simpler, more competitive structures. [The] growth of holding companies was a reflection of the fact that the government required the industry to adopt a holding company structure to do business across geographic barriers and on a regional basis. But today we are seeing a clear market trend for bank holding companies to consolidate their operations into the minimum number of charters possible when they're empowered to do so."

"Last year's VALIC [Variable Annuity Life Insurance Co.] case laid the foundation for a more competitive, more contemporary banking model. VALIC confirmed that national banks are not limited to the specific powers and activities spelled out in the National Bank Act, and [the Supreme Court's] decision directed the [lower] courts to give 'controlling weight to a reasonable construction of the powers of national banks by the comptroller.' The importance of VALIC

cannot be overstated. It is particularly significant given the system of state wild card statutes in place in over 30 states. Taken together, VALIC and the state wild card statutes establish a legal framework in which the bank charter can continue to evolve to meet the needs of the marketplace. . . . As a direct consequence of [the Supreme Court's ruling in the Barnett case] greater numbers of consumers will enjoy the benefits of competition in the insurance marketplace."

"With intensifying competition and the need to stay ahead of the technological curve, you can bet that banks will continue to search for ways to reduce costs. Certainly, the first place where many in the industry urge us in Washington to begin is to reduce regulatory burden and eliminate structural constraints. This need to reduce burden fueled the Riegle-Neal bill's drive through Congress and its enactment into law. But the need hasn't gone away . . . the banking industry continues to drive toward simpler organizational structures when the law permits."

Roberto G. Mendoza



"There are only four [purely wholesale global firms] in the world . . . the Bankers Trust Company, Morgan Stanley, Goldman Sachs, and J. P. Morgan, [although] one must add, from a competitive dynamic, Merrill Lynch. Earlier today there was some discussion as to what would happen if the world was reduced to a situation in which five firms were the dominant providers of wholesale financial services. I would submit that there is no chance that there will be five [because] not all five are going to make it. My bet would be three."

"The biggest boon, but also the biggest challenge, is that dread word 'technology.' Technology has revolutionized the business of being a financial intermediary because the fundamental advantage that a financial intermediary always had was an information advantage. That information advantage has zero value today. The upside is not that human capital has been

replaced by financial capital in the sense that computers do the work. The upside is that [technology] has redefined the business that financial intermediaries provide. They now have the capability to identify, segment, price, and distribute risk in a way that did not exist before and that ability has changed what the clients of banks, poorly defined, expect from those banks. The banks that can deliver what the clients now expect can very quickly change their perceived market position and, by implication, their profitability."

"[Another] thing that technology has done is to commoditize large parts of the business. A global firm's mix of business could be seen as a continuum. On one end is an advisory business, the image of the trusted banker sitting at the elbow of the chief executive, and at the other end is the risk-taking activity, and [this] activity for global banks goes from proprietary trading to making equity investments to some types of derivative transactions where the bank is, in effect, taking pure equity risk. Most of the activity in wholesale banks is in between the two [extremes]. They distribute a risk or a security from the party who doesn't want [the risk] to the party who does want it. Because technology has taken away the information advantage, that distribution process has forced down prices. It doesn't mean that it's a bad business; it simply means that you can do very well at it only if you are a below-cost supplier and have enormous scale. So technology has had the functional effect of taking the profitability out of a large part of the business in the middle."

"[One] fundamental characteristic that will define the successful global wholesale firm is the ability to intermediate risk as opposed to the ability to intermediate information. Currencies have become more volatile, commodities have become more volatile, equity markets have become more volatile. The impact of technology and the ability to combine intellectual capital with the computational ability of the hardware make it possible to segment risks in a fairly precise manner. Once segmented, you can price those risks and the client can retain for himself or herself those risks in which he or she has a comparative advantage in managing. That activity requires a high credit rating because, in order to perform that hedging activity, your client has to believe that you'll be there to pay off, [it will require] a massive investment in technology, and [it will require] very highly developed people—all attributes of a global wholesale firm that has a long-term investment horizon."

Ernest T. Patrikis

"In a number of countries—England and a number of Asian countries—there are codes of conduct, voluntary codes or some promulgated by official bodies, that cover all transactions in wholesale markets, be they gold bullion, foreign exchange, or securities. I asked myself why in the United States we do not have codes and was it possible or desirable to have an overarching code for the marketplace?" [Patrikis called together six associations—the Securities Industry Association, Public Securities Association, New York Clearinghouse Association, the International Swap and Derivatives Dealers Association, and the Emerging Markets Traders Association—to explore whether it would be worthwhile to go forward with a project that would answer this question.]

"A principle that emerged from the project was that all participants in the market are equal participants. There are a lot of people who don't espouse that view; they say clearly there's a difference between the buy side and the sell side and that the buy side needs to be protected from the sell side. One major question is whether every firm that's a dealer in derivatives has to be regulated or supervised."

"But the SEC finds itself in the position [of having information about broker-dealers, but no power to do anything with that information] because it doesn't believe in comprehensive, consolidated supervision. We in the Fed sort of believe in that. I'm hopeful that we'll get to the day when it becomes competent, comprehensive, consolidated supervision. It's the 'competent' that's still missing from that listing. We now have broker-dealer, cross-stream swap subsidiaries, and many people are worried. There are companies that are doing an awful lot of business, and there's no capital adequacy requirement, no regulation, and no supervision."

"We established a system of real self-regulation which is nonstatutory but has limits-the antitrust laws. This effort is a form of real self-regulation, not government-controlled self-regulation. We decided that there would be no supervisors or regulators in the room. We covered participants from the wholesale markets, including such instruments as financial resources, supervision training of employees, control, compliance, risk management, risk monitoring, independent risk monitoring, valuation, and external valuation.

"We also had a concern (growing out of the Procter & Gamble and Gibson Greetings cases, not most cases) of an evolving attitude of heads I win, tails you lose. Markets can't work like that. If I have to have this higher fiduciary obligation as a broker-dealer, I have to change the price of the deal. I've got to charge you for that. I can't give that same price to the party I'm doing the transaction with on an arm's-length deal."

Jay N. Woodworth

"Clearly, a number of major Japanese financial institutions have somewhat impaired financial statements today. That imposes some nontrivial risk on the global settlement system. It is a matter of concern when trillion-dollar financial houses in Japan with somewhat shaky and somewhat unknown financial conditions are doing major transactions that have an enormous impact on markets and financial institutions in the United States and in Western Europe."

"Some things began to change in Japan after Daiwa Bank, with its trading losses and fraud in the United States. Daiwa was initially treated in the Japanese press as yet another example of Japan-bashing by overzealous U.S. regulatory authorities, notably the Federal Reserve, and by hostile American media. However, within the Ministry of Finance, there grew some deep concern that its regulatory compartmentalization had resulted in too little knowledge. The downgrades of debt by public agencies of Japanese banks to near junk levels indicated that something would have to be done, and at the risk of losing foreign access for major Japanese

financial institutions, the Ministry of Finance decided that the banks would have to shape up. The banks were told to write off at least some of their bad loans and comply fully with the 8 percent Basel capital standard by March 31, 1996. Thus far, 8.8 trillion-roughly \$85 billion-has been written off."

"What contributed to the financial crisis in Japan? The rigid compartmentalization of financial institutions. Powers of individual financial institutions were tightly limited and highly restricted. Competition, especially from outside, was very carefully managed in a highly regulated environment. Launching new financial products or services, which is difficult even today, required the specific approval of the Ministry of Finance."

"Japanese manufacturers built onshore facilities in Japan, usually with borrowed funds from the banks. Both [this and excessive offshore investments in U.S. real estate] generated massive losses for the banks as the dollar plunged and the United States endured a recession and slow recovery in 1992. Also there was excessive saving in the early 1990s in Japan, which helped pull down interest rates, erode spreads of financial institutions, accelerate deflation and recession, [all of which] caused a crash in Japanese real estate markets and declines in real consumer spending. Only now is Japan climbing out of what has been its four-year-long recession."

"The Japanese financial sector is larger than the American. Total credit market assets of financial institutions in the United States aggregate about \$5 trillion. Japan's institutions are quite a bit larger, and that's for a country that's one-half the size of the United States. To put it succinctly, the world's second largest financial system, the world's first largest set of depository institutions, is crashing."

Janet L. Yellen



"Credit risk was the major risk incurred by financial institutions since interest rate risk could be managed easily simply by making sure that the contractual interest rate on the loan varied with the cost of funds. Over the past 15 years, traditional intermediation has changed quite dramatically at many of the nation's largest banks. Also, large nonbanks, including investment banks, captive finance companies, and insurance companies, have increasingly become major players in the intermediation process, employing the same technological advances as banks."

"Chief among the innovations at the major banks has been loan securitization. Bank-sponsored

loan securitizations currently involve over \$200 billion in outstanding securities, sponsored primarily by the very largest banks. These securitizations already account for on the order of 20 percent of the credit activities of these large institutions. Securitization holds the potential for completely transforming the traditional paradigm of intermediation. But securitization does not relieve banks of their major traditional job which is to measure, to assume, and to manage credit risk. Indeed, we now know that securitization, as compared to traditional lending, can result in the banks' undertaking as much or even more credit risk."

"The policy issues we face regarding securitization are similar in scope to, although often more complicated than, those we face regarding traditional lending. I think there are two important questions. First, how should we measure the credit risk associated with lending and securitization activities of a bank? Second, how much capital should be required of the bank for a portfolio of given riskiness?"

"I fear we may be reaching the point that, for our largest, most complicated institutions, a bank's formal regulatory risk-based capital ratio, let alone its simple equity-to-asset ratio, is not as useful a signal of financial soundness as we would like it to be. The complexity [of modern credit activities] and the diverse manner in which some of our most sophisticated banks measure and deal with credit risk mean that the broad application of rigid capital rules is becoming less and less appropriate. Indeed, a long-held view at the Federal Reserve is that supervision of risk-taking on a bank-by-bank basis, as opposed to simply the writing of regulations applying to all banks, is the preferred way to assure that credit risk in our banking system is being managed in a prudential manner."

"Nevertheless, at some point, the technology for measuring credit risk will become sufficiently robust to warrant, I believe, a major rethinking of our prudential capital regulations for credit risk. As regulators develop increasing confidence in the ability of banks to quantify and manage credit risk, the natural course will be to find ways to reflect these abilities in our regulatory and our supervisory capital standards. We're attempting to do exactly that now with respect to capital requirements for market risk."

[More complete transcripts of the speakers' remarks and session discussions are published in the conference proceedings. To request a copy, call 845-758-7700 or 202-737-5389 (in Washington, D.C.), fax 845-758-1149, e-mail info@levy.org, or write The Jerome Levy Economics Institute of Bard College, Annandale-on-Hudson, NY 12504-5000.]

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Forums: Immigration and Ethnicity

As part of its research initiative "Ethnicity and Economy in America-Past and Present," guided by Senior Scholar Joel Perlmann, the Levy Institute organized a series of forums on immigration and ethnicity.

Trouble in Paradise: Immigrants and Ethnic Changes in Los Angeles

The first event in the series was a lecture by Roger Waldinger, professor of sociology at the University of California at Los Angeles and author of the forthcoming *Still the Promised City? New Immigrants and African-Americans in Post-Industrial New York*. Waldinger emphasized the ability of immigrant groups to create and capitalize on job niches and their use of networks to facilitate employment for newly arrived immigrants, particularly in blue-collar labor markets. Personal contacts and networks lead to an overrepresentation of immigrants in certain occupations. Korean-owned grocery stores and Indian-owned newsstands are commonly cited examples, but Waldinger has found that the concentration of immigrants extends also to the industrial sector. He states that in 1990 in Los Angeles "Mexican immigrants were heavily overrepresented in 53 of the 82 largest manufacturing industries."

Among the consequences of this self-perpetuating network process is its impact on poor African Americans in metropolitan areas with a heavy concentration of immigrants. Recruitment of workers through immigrant networks, in effect, inhibits African Americans from competing for jobs in the open marketplace. Waldinger cites as a result the relatively small share of African Americans in the manufacturing sector; for instance, only 3 percent of workers in New York's garment industry are African American.

The prognosis for African Americans' competition against immigrants is not optimistic. Few observers anticipate a decline in the number of new immigrants with relatively low skills who will be competing for entry-level jobs. Moreover, new immigrants typically choose to live in cities with existing employer-immigrant networks. This effect is amplified by the perception, false as it may be, among many employers that immigrants work harder and are more productive than African Americans.

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The Levy Report Interview

J. Kenneth Blackwell Discusses Derivatives, Tax Reform, and Affirmative Action



J. Kenneth Blackwell, treasurer of the State of Ohio

J. Kenneth Blackwell, treasurer of the State of Ohio, participated in the Levy Institute's April 1996 conference, "Recent Developments in the Financial System." In 1995 Blackwell was appointed by Senator Robert Dole and Speaker of the House Newt Gingrich to serve on the National Commission on Economic Growth and Tax Reform, chaired by Jack Kemp. Formerly, he was appointed by President George Bush to the rank of ambassador as the U.S. representative to the United Nations Human Rights Commission, was appointed deputy undersecretary at the U.S. Department of Housing and Urban Development, and was elected mayor of Cincinnati.

Sanjay Mongia, assistant director of the Levy Institute, spoke with Treasurer Blackwell on May 8, 1996, to explore the treasurer's views on a wide range of economic and social concerns. Excerpts of their conversation follow.

Mongia: You stated that a lack of political will to raise taxes and scarce resources have encouraged public fund managers to take unwarranted risks in their quest for new sources of revenue. Will reduced aid from Washington prompt states and municipalities to undertake greater risks in pursuit of higher rates of return and more revenue?

Blackwell: The situation will be right for that sort of dilemma in state legislatures and city councils. If we don't fortify public fund managers with more capacity to resist political prodding and pushing, then you will find them taking greater risks in order to create a new cash cow. Incidentally, this becomes more of a problem as more time passes since the last catastrophe; as people forget the crisis, the political demand for a new stream of unrestricted revenue intensifies. That's why my efforts to fortify public fund managers intensify as time passes since the Orange County fiasco.

Mongia: You suggest that derivatives are not inherently evil. Why do you want to regulate, in this case prohibit, municipal involvement in derivatives?

Blackwell: Because I believe that there is a distinct difference between investing tax dollars and investing private dollars. No one—not even the strongest proponents of the use of derivatives—suggests that there is no inherent risk in their use, but when appropriately used, in the private sector, derivatives can hedge risk, particularly in portfolios of longer duration. The cash management portfolios that local public fund managers are handling should be of shorter duration and be as risk averse as possible. By definition, investing in riskier, more complicated securities fails to meet, for us, a prudent person principle.

Furthermore, it is important to keep in mind that we don't have continuing education or certification requirements for most of our public fund managers at the local level. In the case of county treasurers—and even the state treasurer in Ohio—people might be elected because of their friendly disposition, their charm, or their looks. Often in the relationship between Wall Street and Main Street, there is an asymmetry of information and experience, and this imbalance is amplified by the powerful seduction of Wall Street.

The technological and perceptual changes in high finance are astounding. Many public fund managers have little background; they are soon in over their heads and inevitably need advice. The problem is that often they don't know how to sort out the competing claims of expertise. Firms court the local public fund managers by wining, dining, and drowning them in working papers, and, all too often, the managers are tempted to take a bite out of that apple.

Mongia: As a member of the Kemp commission on tax reform, do you endorse a pure flat tax, that is, a single rate that taxes only earned income with no exemptions and no deductions?

Blackwell: I support a single rate tax system that has three deductions. The first deduction is the employee's portion of the payroll tax. Currently, the employer can deduct it, but the employee cannot. We have young Americans and new entries into the labor force who pay more in payroll tax than they do in income tax. The second deduction is mortgage interest. If you believe that all income should be taxed once, then the question becomes which source to tax. Since we tax the interest received by the lender, then, from the Treasury's standpoint the mortgage interest deduction is a wash. The third deduction is charitable contributions. It's probably politically foolish to get into an arm wrestling match with Mother Theresa. No politician wants to incur the wrath of every religious and charitable leader, especially since we may be asking charities and voluntary organizations to pick up a greater burden as we proceed with the transition from welfare to work.

Mongia: Are you concerned that exempting capital income from taxation will further skew the income distribution in this country and lead to increasing inequality?

Blackwell: First, I believe that we demand too much from our tax system and our tax code. The

legitimate and, I believe, the only justification for the tax code and the federal tax system is to raise the dollars necessary to fund the legitimate activities of the federal government. We have now expanded the responsibilities of the code and the system to redistribute income from those with more wealth to those with less.

The current tax code also provides the context in Washington for the herds of lobbyists trying to get an individual break, preferential treatment, or some relief for their clients. If we eliminate the exemptions and deductions, we will reduce the complexity of the tax code and turn it's focus back to its original purpose-to raise the revenues necessary to fund the government's legitimate activities.

The national debate over tax reform reflects a fundamental clash in worldviews. Perhaps I have missed the point, but I do not believe that the expressed purpose or justification for the tax code is to facilitate and effect social justice.

Mongia: However, there are unintended consequences of policy actions. By taxing only labor income and exempting capital income, wouldn't the tax code still be an instrument of social engineering, providing a disproportionate benefit to the upper end of the income spectrum?

Blackwell: We should always be sensitive, in the law, to unintended consequences. But I think we have to make a fundamental decision about not just the arithmetic of tax reform, but also the morality of tax reform. The commission recommended taxing income once and only once. That's a moral determination consistent with the arithmetic of a single-rate system with a generous personal deduction.

Take a hypothetical situation, assuming a flat tax rate of 20 percent with a personal exemption of \$30,000 to a family of four. A family making \$50,000 pays 20 percent of \$20,000, or \$4,000. That's 8 percent of their total income. A family making \$100,000 pays 20 percent of \$70,000. That's \$14,000, 14 percent of their real income. As income increases, so does the level of taxable income. Progressivity is inherent in the math of the flat tax formula. That's the mathematician's progressivity; it can't be argued or tampered with because it's totally objective. It's truly moral, because it doesn't allow for subjective judgments. The so-called progressive rate structure, however, applies the politician's progressivity, which is a totally subjective determination of how well-off is too well-off. Just how subjective it is is evidenced by the 4,000 changes in the tax code since the last major overhaul in 1986.

The same argument extends to corporate dividends. Someone somewhere has made a decision about the "kind of people" who profit from investments. And that's supposed to justify taxing that kind of income repeatedly. First, we tax the income used to buy shares. Second, the corporation is taxed on the company profits, before dividends. And those dividends are taxed yet again as income to the shareholder.

The answer is tax income only once-at its source. The moral argument is the same for any type

of income-labor or capital. You don't make subjective judgments about a certain "kind of people" based on how they make their money. By eliminating the bias against capital investors, one term will be sufficient to describe that kind of people, anyway, and that term is American.

Mongia: You have said that income distribution is not a responsibility of the tax code. However, is widening income inequality a public policy concern, and if so, what can be done to address it?

Blackwell: Widening disparity is a legitimate public policy concern, but I believe that public policy should address the need for greater education and skill development. What are we doing in terms of literacy? Intractable illiteracy in the inner city is more of a threat to the economic well-being of poorer people than to Bill Gates or Steve Forbes. If we do not make literacy a top public concern, we are only artificially attending to the problem; we are not attending to the real factors responsible for widening inequality. Without portable skills these young people will be at a competitive disadvantage in an information age.

Mongia: The Federal Reserve has declared that annual GDP growth beyond 2.5 percent would trigger accelerating inflation. What do you believe is the appropriate role for monetary policy in today's economy?

Blackwell: I had the opportunity and pleasure recently to spend an hour with Federal Reserve Chairman Alan Greenspan. I tend to believe that the Fed is a bit overcautious, a bit too afraid of growth. I understand and appreciate what Mr. Greenspan told me about the importance of price stability. I take great comfort in his assurance that he, the other Fed governors, and the Fed staff understand that the only way to deal with the citizenry's sense of "economic anxiety," which is propped up by wage stagnation and job insecurity, is to push growth beyond the 2.5 percent mark. Understanding that the Fed isn't likely to give up its overly cautious point of view, I am confident that it will do the right thing in terms of allowing the economy to expand in a way that can improve morale and opportunities in our country. We have two different ways of approaching the problem of economic insecurity, but we do not have two different desired results.

Mongia: There is currently a debate about the nature of corporate citizenship. Institutional shareholders (namely, pension funds and mutual funds) are having much greater influence in corporate board rooms and in shaping the decision-making of firms. Do you believe that institutional shareholders bear some responsibility for the effects-such as the negative effects on job security-of the downsizing and restructuring of corporate America?

Blackwell: They should be credited to some extent for the restructuring of corporate America that has moved us toward greater efficiency and higher productivity. But given the nature of corporate governance and since institutional shareholders are at the table, their fingerprints are also on the knife and they are labeled as culprits responsible for the downsizings. But I tend to believe that outsourcing, downsizing, and restructuring of big corporations are necessary to

achieve greater efficiency and create new enterprises. This will position the United States competitively in the twenty-first century.

Mongia: Washington is moving in the direction of shifting greater responsibility to states and municipalities. Do you believe that these entities are financially and structurally equipped to cope with any additional burdens?

Blackwell: It's hard for me to make blanket assessments. A state's responsibility is to identify needs, identify the state's proper role in meeting those needs, and prioritize the needs. States that can creatively manage and leverage block grant dollars should be equipped to meet needs with available resources. In the state of Ohio, we are well positioned for devolution. I think the governor has been smart, ignoring even my prodding for state rebates. We have created a billion dollar "rainy day" fund. In my view, it is \$250 to \$500 million more than we actually need, but we are prepared for the transition period as those responsibilities and programs devolve back to the state.

Importantly, the process of devolution can't stop at the state level. At the state level we have to sort out programs that should be executed at the municipal level. At the municipal level we need to identify what should be done on a neighborhood level and a family level. We should move toward individual responsibility with the intention of creating neighborhoods that look to self-help and market solutions. The full impact of devolution will be felt only when we instill an understanding of how to get back to doing the basics well and we witness reduced demand on municipal governments. I certainly do believe that the government that is closest to the people is the government that works best. Governance structures, whether they are neighborhood councils or municipal governments, that keep some element of individual responsibility in the delivery system are much better than systems that are operated by bureaucrats who are located hundreds of miles away and who don't understand the difference between how things are done in St. Louis and how they are done in Cincinnati.

Mongia: President Clinton has remarked that America needs to "mend, but not end" affirmative action. However, the University of Texas case may have further clouded the issue. Should we maintain an affirmative action policy, and if so, how should it be tailored?

Blackwell: The sole dissenting view in *Plessy v. Ferguson* was a compelling case made by a single justice, and it became the centerpiece of the civil rights movement. That view clearly denounced arguments for racial preferences and racial classifications in any government-sponsored activity. The Constitution is color-blind in that the inalienable rights it guarantees are not conditional on color, gender, or religion. Therefore, any government-sponsored activity based on racial, color, or gender specificity is operating in a matter inconsistent with the Constitution of the United States. America is evolving; it needs more than racial remedies for the problems of poverty, isolation, and joblessness. I find it ironic that those who made that case now argue that there should be special government programs to give preferential treatment to people on the basis of gender and color. We should be approaching affirmative action on the

basis of need and opportunities for growth, regardless of color.

It should be clear that an individual will not be the beneficiary of affirmative action for his or her entire life. Once you enter the affirmative action program and benefit by it, you no longer are eligible for preferential treatment; once you create a level playing field, affirmative action must have a particular shelf life.

I also believe that there must be some way of assessing need. My father, who was directly discriminated against, could have been a beneficiary of affirmative action. He sent me to school, and I have become treasurer, mayor, and U.S. ambassador. Is it right or just that my children, simply on the basis of their color, should be the beneficiaries of affirmative action? I believe that the answer to that question is no.

But that does not mean that in phasing out eligibility for affirmative action, we should license blatant racial and gender discrimination. This is the point on which I disagree with some of my colleagues on the right. They want to do away with affirmative action, but they're not willing to demonstrate their tenacity in continuing to fight racial and gender discrimination. I am a devoted free marketer and believe that talent, merit, and motivation should be the bases of success. When people turn a blind eye to situations where talent, merit, and motivation are not allowed to get individuals on the ladder and to determine if they move up the ladder, then I suspect that they may be using their professed belief in a free market to protect an advantage or privilege that was created in something other than a free market.

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New Working Papers

Uncertainty and the Institutional Structure of Capitalist Economies

In Working Paper No. 155, Distinguished Scholar Hyman P. Minsky points out that capitalism in the United States is an evolving construct that recently entered a new stage, "money manager" capitalism. In money manager capitalism, nearly all businesses are organized as corporations, pension and mutual funds are the predominant owners of financial assets, and managers of these funds are judged solely on the total return on fund assets (dividends and interest plus appreciation in share value). One consequence of such a structure is the predominance of short-run considerations in decision making.

Public tolerance for uncertainty is limited. During the New Deal era it led to the creation of institutions and arrangements to create transparency in both financial markets and corporate governance. For example, crop insurance set floors to farmers' incomes and deficits run by the federal government set floors to aggregate profit flows. However, the focus of money manager capitalism on short-run returns and uncompromised profit margins has increased economic uncertainty at the firm and plant levels through the chronic need to downsize overhead and reduce variable costs. These activities have unraveled the traditional relationships between firm and worker and increased economic insecurity among employees.

Minsky asserts that existing institutions and programs cannot contain this uncertainty and new arrangements must be created to offset the effects on "losers" in the structure of money manager capitalism. Such measures are necessary to prevent these individuals from becoming alienated and thus recruits for an alternative to democracy. He suggests that full-employment programs analogous to certain New Deal programs (the Work Progress Administration, the Civilian Conservation Corps, and the National Youth Administration, for example) should be considered to meet this goal.

How will these programs be financed? According to Minsky, the U.S. economy has ample resources, but the question is one of a willingness to mobilize these resources, that is, to tax and borrow for such projects. For example, welfare in its current form (AFDC and food stamps) exists because it is the cheapest way (short of a policy of doing nothing at all) to take care of the population in need. Full employment policies are more humane, but more expensive and require a larger and more innovative public sector.

For government to institute programs to offset the uncertainties of money manager capitalism, it must validate government debt with government revenues. The current high ratio of government debt to gross domestic product (GDP) is the result of the irresponsible fiscal policies of the 1980s; a responsible program would assure the decline of the ratio of federal debt to GDP over time from the current 65 percent to about 50 percent. This could be accomplished by the transformation of the tax structure to a value-added revenue system in which, for example, the individual income tax is replaced by a progressive consumption tax with broad bands and a high per person deduction and value-added taxes are levied on production or distribution and on imports. Imposing such a revenue system would allow the United States to transform its economy from one based on transfer payments to a full-employment economy, from one that generates resentment to one that generates support of democracy.

[Editor's note: This paper was presented in January at the ceremony in which Minsky received the 1996 Veblen-Commons Award, given in recognition of the contribution made by an outstanding scholar in the field of evolutionary institutional economics.]

Economic Insecurity and the Institutional Prerequisites for Successful Capitalism

In Working Paper No. 165, a paper marking the fiftieth anniversary of the Employment Act of 1946, Distinguished Scholar Hyman P. Minsky and Visiting Scholar Charles J. Whalen search for reasons to account for the split in post-World War II economic performance, that is, the difference in performance between the 1946 to 1966 period and the 1966 to 1996 period. The authors discuss a number of economic problems that have arisen during the past quarter of a century, including slower growth, stagnant earnings, rising financial instability, and increasing inequality. Minsky and Whalen concede that factors such as globalization and technological change have undoubtedly played a role in the split performance. An additional important and often overlooked element is the evolution of the U.S. financial structure. The authors explain that a key component influencing the evolution of the financial sector during recent decades has been the rise of "money manager" capitalism. Important features of money manager capitalism are increased financial fragility (lower margins of safety in indebtedness and a greater reliance on debt relative to internal finance) and the introduction into the financial structure of a new layer of intermediation. In particular, managers of pensions, trusts, and mutual funds currently control the largest share of the liabilities of corporations. These managers are judged by only one criterion: how well they maximize the value of funds. As a result, business leaders have become increasingly sensitive to the stock market valuation of their firm.

Minsky and Whalen assert that current economic problems require that we reconsider how to measure economic success. In the early postwar period American policymakers could focus on overall economic growth, unemployment, and inflation. These measures, however, are no longer sufficient as indicators of citizen well-being given existing wage stagnation and widespread employment insecurity resulting from longer employment searches, increased dependence on multiple job holdings, and the explosive growth in part-time and contingent work.

The authors then outline the institutional prerequisites for a new stage of capitalism, which they call "shared prosperity" capitalism, in which economic security and social progress are mutually reinforcing. One prerequisite is a federal government that encourages competition among firms through innovation, improvement of product quality, and development of new markets, rather than through a reduction of labor costs. Other prerequisites are a national network of community development banks and a public sector that serves as employer of last resort.

Minsky and Whalen argue that it is possible to reduce present-day insecurity without sacrificing economic progress. The Employment Act should be commemorated not merely by looking back at the past fifty years, but by looking ahead toward a new era of institution building: "The goals of the Employment Act are best honored by working to achieve a new age of shared prosperity."

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Lecture Series

ALAN KRUEGER: The Legacy of Separate and Unequal Schooling

Alan Krueger, professor of economics at the Woodrow Wilson School of Public and International Affairs at Princeton University, spoke about the legacy of separate and unequal schooling in the United States. He noted that the evidence about the effects of school segregation is weak because specific data on schools before the late 1960s was not collected. However, using responses to the National Survey of Black Americans, Krueger was able to gauge the extent of school segregation to show that schools were segregated prior to 1964. He found a sharp decline in racial segregation after 1964, contrary to studies in which 1968 was found to be the watershed year. He determined that student-teacher ratios were higher in segregated schools and that spending was lower in black districts. Krueger attempted to find the extent to which these factors affected later earnings.

In a study with David Card, Krueger found that for a given level of educational quality (measured by, for example, student-teacher ratio, length of the school term, and teacher pay), in general, earnings rose as the number of years of schooling increased. Therefore, those blacks who grew up in states with lower quality schools earned less, on average, than those who grew up in states with higher quality schools. The gap, however, between average white and black earnings closed from 40 percent in 1960 to 25 percent in 1980, with roughly 20 percent of the narrowing resulting from improvements in the relative quality of education. Krueger noted that evidence indicates that antidiscrimination efforts were responsible for much of the remaining reduction of the gap.

What would have been the effect on earnings if the school resources of black schools from the past had been as high as the levels spent in white schools? Examining data from the 1920s cohort, Krueger found that per pupil spending in white schools was about 150 percent higher than in black schools; he estimates that with equal spending blacks would have earned about 21 percent more than they actually did. He also estimates that in 1970 (when the 1920s cohort would have been in their prime working age) the actual gap in resource spending accounted for 40 percent of the black-white earnings gap (which at that time stood at 48 percent).

Krueger also noted that lower quality schooling might lead a student to complete fewer years of school. He tentatively estimates that lower spending on the 1920s cohort lowered educational attainment by about 15 percent. Moreover, lower educational attainment and earnings by parents likely affect attainment and earnings of their children. Krueger estimates this intergenerational transfer of earnings—that is, the reduced earnings for the 1940s cohort resulting from lower educational attainment and earnings of the 1920s cohort—at about 8 to 12 percent.

Krueger noted that all of his calculations were meant to be illustrative rather than precise point

estimates. Among his caveats were that school spending might not capture all important and relevant aspects of school quality and there is considerable uncertainty about the effect of school resources on subsequent income, employment, and educational attainment. Despite these warnings, he concluded that "this exercise highlights that the separate and drastically unequal schooling endured by previous cohorts of African Americans probably casts a long shadow over current and future generations of black workers." Race matters, at least in part, because race used to matter.

ROBERT FRANK: Economic Policy for a Winner-Take-All Society

Robert Frank, Goldwin Smith Professor of Economics at Cornell University, explored possible explanations for the fact that certain individuals within any profession are more valued (that is, higher paid) than others within their spheres of operation. Although most of us can easily understand this phenomenon in the context of sports and entertainment, Frank's research found it is also true in other occupations, including business, law, and medicine. He considered whether the increase in income among the very highest earners within an occupational grouping is a factor that has contributed to the growing overall income gap.

Most economists focus on differences in human capital endowments (such as education) to explain gaps in income distribution. Frank contended that although there have been no large shifts in the distribution of human capital, there has been increasing variation in the incomes of individuals possessing similar endowments. He observed that, within a specific market, certain individuals (winners) earn substantially more than otherwise similar individuals.

Frank noted a number of characteristics defining a winner-take-all market, including rewards based on relative (rather than absolute) performance and the concentration of those rewards in the hands of a few top performers. For example, the growing disparity between average CEO and average worker salaries is, in part, the result of the rising pay to a select group of CEOs. This higher pay is the result of the higher leverage of the few top candidates and the open competition among all firms for these "best" few. High leverage results from the high costs associated with a firm's failure. Although the relative differences in decisions made by any two CEOs might be extremely marginal, the results of those differences can be large in terms of relative position in the market and financial payoffs. Other possible reasons for wider income dispersion within professions include the ability to clone the achievements of the top performers at a relatively low marginal cost (which allows relatively easy access to the best performances and substantially reduces the demand for lesser-quality performances) and network economies (the phenomenon in which a product gets more valuable as more consumers buy it, such as in the case of VHS recorders or IBM's MS-DOS system).

All of the effects mentioned by Frank grow over time, in part because of feedback from each effect to itself and to other effects. The costs of a winner-take-all market are a more highly skewed income distribution and an inefficient allocation of resources (the latter resulting from

overinvestment in becoming a "winner"). The benefit of a winner-take-all market is that access to the "best" goods is increased. Frank noted, however, that these same goods could be obtained at a lower cost than at present if fewer resources were invested by those competing to become "winners." He proposed that taxation could be used to alleviate the costs of winner-take-all markets while preserving their benefit. These goals might be accomplished through such means as taxes imposed on very high income earners and a progressive consumption tax, with the latter levied on the difference between income and saving.

RICHARD J. MURNANE: The New Basic Skills

Richard J. Murnane, professor of economics at Cornell University, discussed findings presented in his forthcoming book, *The New Basic Skills*, co-authored with Frank Levy. He noted that changes in the economy have affected the level of skills necessary for a high school graduate to obtain employment at a middle-class wage. Earnings among male high school graduates have declined since 1979, both in absolute terms and relative to college graduates. Higher skill levels are required in the workplace, employers are paying higher wages to workers possessing these skills, and high-paying employers have become more selective in choosing employees. Therefore, skills matter more in determining earnings levels.

Murnane and Levy's conclusions were based on two large sets of panel data, the first of individuals graduating from high school in 1972 and the second of individuals graduating in 1980. They examined this data to determine the relationship between math and reading scores on standardized tests and earnings levels six years after graduating. They found that the differences in earnings between high- and low-scoring individuals was larger for the second panel than for the first, and strong math skills were more important in determining later earnings for the second panel.

The authors found that all employers still value the "old basics" of timeliness, hard work, and a positive attitude, but high-paying firms demand more of their workers; they demand what Murnane and Levy call the "new basic skills." These firms expect employees to be able to:

- read and do math at a ninth-grade level
- solve semistructured problems by formulating and testing hypotheses
- communicate effectively orally and in writing
- work productively in groups with people from different backgrounds
- work with computers

Schools in general are not doing well at teaching these skills because it is difficult to get agreement that they are necessary. Murnane noted that parents do not typically call for change unless they are very dissatisfied with the education that their child is receiving. Students often do

not feel that these skills are important because there is no short-run return to such skills. Teachers are not necessarily trained to teach the new skills. Moreover, the predominant testing device-multiple choice-cannot measure students' ability to perform the new basic skills, yet these tests continue to be used to measure student performance and teachers continue to be trained to teach students how to pass such tests.

Murnane suggested five principles by which schools can improve student performance on the new basic skills. First, teachers, parents, administrators, and students must agree that acquiring the skills is important and that the schools have been failing to provide adequate training. Second, work on solutions must be designed so that teachers, parents, administrators, and students have both the incentive and the opportunity to contribute. Third, everyone involved must be provided with the training needed to pursue solutions effectively. Fourth, progress must be measured regularly. Fifth, all must persevere and learn from their mistakes; there are no "magic bullets."

A question not answered by Murnane is whether skill enhancement will boost the number of high-paying jobs for high school graduates. Murnane noted that some employers currently hire college graduates for jobs that high school graduates with the new basic skills could perform. Unfortunately, screening for the new basic skills is costly, and rather than incur such costs, employers simply increase their educational requirement. Increasing the proportion of high school graduates who have the improved skills would probably increase high school graduates' share of high-wage jobs. However, it remains to be seen if supply-side factors will be sufficient to increase the number of such jobs.

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