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Letter from the Executive Director

To our readers:

This issue of the *Summary* includes activities in three research programs and special topics. There are four new working papers in the employment policy and labor market structure program. Resident Scholar Oren M. Levin-Waldman believes that at the core of the minimum wage issue is a question of social justice and the type of society we want and that this question has been largely ignored in favor of cost-benefit analysis in the public debate on the issue. Philip Moss, of the University of Massachusetts Lowell, suggests that an important factor in the growth of earnings inequality in the United States is firms' strategy regarding pay, skill, and technology. Research Associate Roger Waldinger and Senior Scholar Joel Perlmann examine the economic prospects of the children of immigrants and conclude that the fear of "second-generation decline" is greatly exaggerated. Based on a case study of the automobile industry in the United States and Japan, Research Associate William H. Lazonick finds that the U.S. corporate strategy of confining organizational learning to a narrow, concentrated skill base has caused the United States to lose both market share and good jobs.

Research in the program on restructuring in the financial services sector is represented by an examination of the cost of currency stabilization in Ukraine by Visiting Scholar David Alan Aschauer. His answer to the question "*Skiki vono ko shtuvalo* (how much did it cost)?" is that the cost has been surprisingly moderate and is likely to be matched or exceeded by the long-run benefits.

In the international trade and competitiveness program Robert Forrant, of the University of Massachusetts Lowell, analyzes the U.S. machine tool industry and concludes that industry mistakes and lack of coordination caused the United States to drop from the world's largest exporter to a net importer of machine tools.

Two working papers by Malcolm Sawyer are summarized under special topics. He contends that the nonaccelerating inflation rate of unemployment (NAIRU) is weak on both theoretical and empirical grounds and that it neglects the role of aggregate demand in determining the sustainable unemployment rate.

This issue also includes a synopsis of the work of the past year's Cambridge University visiting scholars on European monetary union, the shareholder revolution in the United States, and investment in the transition economy of Russia.

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

Dimitri B. Papadimitriou
Executive Director

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New Working Papers

Minimum Wage and Justice?

Oren M. Levin-Waldman
Working Paper No. 197, July 1997

Opposition to the minimum wage, according to Resident Scholar Oren M. Levin- Waldman, ultimately rests on a popular political philosophy and a popular economic theory. The popular version of classical liberal philosophy stresses individualism over the common project and accordingly puts the employer's right to pay low wages over the common goal of a high-wage economy. The predominant economic theory stresses efficiency over any common goal and presupposes that unregulated markets are naturally efficient.

According to Levin-Waldman, this economic theory views the market as perfectly competitive; left on its own, it operates efficiently to allocate goods and to pay all factors what they are worth. Any inefficiency is blamed, without proof, on government interference with the market. If individuals are dissatisfied with wages, they may look for another job or improve their skills. A minimum wage, if it is above the wage that would otherwise prevail, artificially increases wages above the marginal product of labor, reduces employment, and is, therefore, inefficient. In Levin-Waldman's view, most economists, wanting to focus only on objective criteria, conclude that consideration of this supposed inefficiency alone ought to drive the public policy process.

Levin-Waldman offers a philosophical and economic critique of opposition to the minimum wage. His economic critique disputes that the perfectly competitive marketplace exists and that inefficiency is always a consequence of the minimum wage. First, the natural operation of the

market requires that individuals be free to engage in contracts. However, because of the distribution of market power, the only contractual freedom workers have is to accept or reject the going wage, which is tantamount to a choice between eating and starving. Second, wages are determined more by social convention than by natural market forces. Third, there is no conclusive proof that an increase in the minimum wage causes increased unemployment. Fourth, some research indicates that an increase in the minimum wage not only drives up wages of those making the minimum, but drives up wages in general. Fifth, a higher minimum wage gives employers a greater incentive to train workers, raising their productivity and, therefore, increasing efficiency. Levin-Waldman concludes that there is no hard evidence either that an increase in the minimum wage is inefficient or that it is not.

According to Levin-Waldman, the philosophical opposition to a minimum wage is based on a conception of liberalism that overemphasizes individualism. According to this conception, society should not violate individual rights (in this case the right of the employer to pay low wages) unless there is compelling evidence that doing so will serve a larger public interest. However, exclusive emphasis on individualism may create conflict with other equally important liberal values--mutuality, self-sufficiency, and the common project. If work is considered to be an essential part of participation in the common project, a minimum wage is necessary to ensure that workers and employers have a mutual obligation, that is, that the obligation of workers to work is matched by a reciprocal obligation of employers to pay them enough so that they can be self-sufficient. When viewed from this perspective, a worker's right to self-sufficiency should not be abridged (in this case by failing to set a high enough minimum wage) unless there is forceful evidence that abridging it would benefit the community.

Levin-Waldman concludes that a society that stresses the values of mutuality, self-sufficiency, and the common project needs a minimum wage. The debate on the minimum wage should not focus on the narrow economic concept of efficiency, but on the broad philosophical question of the kind of society we are trying to create.

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

Philip Moss
Working Paper No. 198, June 1997

The increase in earnings inequality in the United States is now a widely accepted fact that much economics literature has attempted to explain. Philip Moss, of the University of Massachusetts Lowell, examines the increase in inequality, evaluates the frequently given explanations for it, and offers an improved methodology for determining its causes.

The increase in inequality in the United States has been substantially higher than in other industrialized nations. Workers at the low end of the earnings distribution have experienced not only a relative decline but an absolute decline in earnings. This pattern reversed a historical trend of rising economic activity and decreasing poverty. Fringe benefits have continued to increase (although at a much slower rate than in earlier decades). However, benefits are distributed even more unevenly than wages, so that the distribution of total compensation is even more unequal than the distribution of monetary compensation. Adding to the drop in the low end is the decrease in the social safety net, a greater decrease in the United States than in other industrialized countries.

The most frequently given explanations for the increase in inequality usually stress one of three types of factors: labor supply, labor demand, or labor market institutions. Moss adds a fourth, firms' strategic decisions regarding pay, skill, and technology, but at the same time he suggests that no one factor or type of factor taken by itself can explain the entire trend.

Supply factors include an increase in the supply of low-skill workers and a decrease in the supply of high-skill workers caused by a slow-down in growth of numbers of more- educated workers,[1] an increase in immigration of low-skill laborers,[2] and an increase in the supply of low-skill workers caused by a decrease in the demand for middle-strata workers, which forces some of them into the low-skill market.[3]

Demand factors include changes in technology causing an increase in the demand for high-skill workers and a decrease in the demand for low-skill workers. This seems to be the most popular explanation, although there have been difficulties in verifying it empirically. For example, the relative wages of college graduates have increased significantly in part because of the absolute decline in wages of people with a high school education or less. The evidence for technology as a driving factor also is inconclusive. Pointing to the use of computers on the job to explain the increase in the demand for educated labor is unconvincing because the major jump in the use of computers happened in the late 1980s, well after the decrease in wages had begun. The change in wages by industry has not been consistent with the change in the use of computers by industry. Wages of truck drivers and other workers whose work has been relatively unaffected by computers have declined, while wages of store clerks and other workers who have seen a great increase in computerization have also declined.

Another possible explanation is that the growth of international trade has increased the demand for domestic high-skill workers and decreased the demand for domestic low-skill workers. Moss cites studies that attempt to link skills and inequality; these studies show that skill demands have increased, but not at the pace necessary to explain the size of the trend in inequality.

Institutional factors used to explain rising earnings inequality include the decline of unionization and the real decrease in the minimum wage. A few analysts consider both of these to be the result of a major shift in public policy and an active strategy of management to reduce the labor market power of workers. This view is boosted by an international comparison. European countries have seen similar supply and demand changes as the United States but not the same increase in inequality, possibly because they have not experienced the same assault on labor market institutions. Some would argue that European countries have adjusted to supply and demand changes through higher unemployment rather than through inequality, but Moss asserts that the evidence does not support a simple trade-off between inequality and unemployment.

A fundamental problem with the existing statistical evidence is that skill and technological change are unobservable and can be measured only by inference from such variables as education, wages, and use of computers.[4] Moss proposes that other methods of research, including historical, comparative, and case study approaches, would help extend understanding of the causes of wage inequality.

Case study evidence has shown that the introduction of new technology, including computers, can be associated with either an increase or a decrease in the demand for skilled labor. In Michael Handel's examination of survey data, he finds the opposite of what the demand-shift hypothesis predicts; he observes a decrease in the portion of workers who report needing specific skills to obtain their current job and a decrease in those receiving on-the-job training.[5] These conditions, however, are determined not by inexorable market forces but by whether the firm chooses a high-skill/high-wage strategy or a low-skill/ low-wage strategy. Moss suggests that case studies can be more useful than econometric analysis in determining the effects of firms' strategic decisions and in shedding light on changes in the distribution of income.

Notes

1. Lawrence F. Katz and Kevin M. Murphy, "Changes in Relative Wages, 1963-1987: Supply and Demand Factors," Quarterly *Journal of Economics* 107, no. 1 (1992).

2. George Borjas (1994), as cited in Lawrence Mishel, Jared Bernstein, and John Schmitt, *The State of Working America,* 1996-1997 (Armonk, N.Y.: M.E. Sharpe, 1997).

3. George Borjas, Richard Freeman, and Lawrence Katz, "On the Labor Market Effects of Immigration and Trade," in George Borjas and Richard Freeman, eds., *Immigration and the Work Force* (Chicago: University of Chicago for National Bureau of Economic Research), 213-244.

4. Mishel, Bernstein, and Schmitt, *The State of Working America.*

5. Michael Handel, "Skills and Work in America in the Twentieth Century," mimeo, 1994.

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Second Generations: Past, Present, Future

Roger Waldinger and Joel Perlmann
Working Paper No. 200, August 1997

Many scholars have expressed concern about the ability of today's second-generation Americans (the children of immigrants) to assimilate and move up the socioeconomic ladder. Some describe "second-generation decline," or the failure of the children of immigrants to reach their parents' level of achievement; others speak of "segmented assimilation," or the assimilation of some immigrants into mainstream American culture but of others into the urban underclass.

This apparent failure is explained as resulting from changes in the structure of the economy that make it more difficult for today's immigrants and their children to follow the path into the middle class taken by many immigrant families in the late nineteenth and early twentieth centuries: Immigrants took low-skill factory jobs; their children and grandchildren moved into better-paying blue-collar jobs and eventually reached managerial or white-collar jobs. Many scholars worry that this path, which requires a large factory-based economy, is no longer possible in today's "hourglass economy," with many good jobs at the top, many bad jobs at the bottom, and few decent jobs in between. Those who cannot make the transition in one generation to become college-trained professionals are forced into the urban underclass.

Research Associate Roger Waldinger, of the University of California at Los Angeles, and Senior Scholar Joel Perlmann assess this pessimistic view of the fate of the children of immigrants. Although they are sympathetic to such concerns, they find that a careful comparison with past assimilation patterns reveals reasons to be optimistic about today's and tomorrow's second generations.

According to Waldinger and Perlmann, one weakness in the perception of a second- generation decline is that it fails to take into account the relative size of the portion of today's second generation that is either stalled or headed downward. In fact, a large portion of recent immigrants arrive as or soon become middle class, whereas that was so for only a few in the early twentieth century. Many immigrants and their children are making a leap up in our educational system and the income ladder. For example, 18- to 24-year-olds in every Asian group in Los Angeles attend college at a higher rate than whites.

Waldinger and Perlmann find that those most at risk for segmented assimilation are Mexicans. Mexicans are by far the largest immigrant group in the United States, and they are at the bottom of the skill ladder. If the statistics on Mexicans are removed from the statistics on all immigrant groups, today's second generation varies little in socioeconomic characteristics from the rest of the American population. At the turn of the century there was no single group that was large enough and consistent enough in characteristics to have altered the generalization that was true at the time that most immigrants were much more likely than natives to start at the bottom of the income distribution.[1]

Another reason offered for second-generation decline is that today's children of immigrants face greater discrimination than past second generations because many of them are nonwhite. However, like beauty, race is in the eye of the beholder. At the time that eastern Europeans, southern Europeans, and Jews arrived, they were not considered "white" by most of American society. Although discrimination still exists, Waldinger and Perlmann assert that American society today is more open to incorporating immigrants and their children than it was at the turn of the century, largely because of the efforts of earlier groups of outsiders to increase civil rights and widen opportunities.

Waldinger and Perlmann are cautiously optimistic about the prospects for today's and tomorrow's second-generation Americans. The path to upward mobility is different from that in the past, but new opportunities exist and most of today's immigrants and their children are in a better position to take advantage of them than immigrants in the past.

Note

1. Joel Perlmann and Roger Waldinger, "The Second Generation and the Children of the Native Born: Comparisons and Refinements," Working Paper No. 174, The Jerome Levy Economics Institute of Bard College.

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Organizational Learning and International Competition: The Skill-Base Hypothesis

William H. Lazonick
Working Paper No. 201, August 1997

The U.S. economy has grown and has been capable of innovation for decades, but has not achieved sustainable prosperity in the sense of spreading the benefits of economic growth to many people over a prolonged period of time. Over the last three decades, despite economic growth, the nation has experienced both increasing relative inequality and an absolute decline of real wages.

Explanations sometimes offered for this inability to achieve sustainable prosperity are a weakening of innovative ability (a result of reduced expenditures on training, education, and research) and international competition from low-wage countries (forcing down U.S. wages). Research Associate William H. Lazonick, of the University of Massachusetts Lowell and INSEAD, champions a third explanation, the skill-base hypothesis.

The skill-base hypothesis defines two strategies of human resource investment: A broad and deep skill base uses skilled work by many people, at different levels of the organizational hierarchy, and across organizational functions; a narrow and concentrated skill base uses skilled work by a small and elite portion of the labor force. According to the hypothesis, changes in technology and international competition have been important factors relating to level of sustained prosperity, but not for the reasons usually given. Lazonick observes that U.S. firms are still innovative, but tend to invest in technologies that require a narrow and concentrated skill base. International competition has been important, not primarily because foreign wages are lower, but because other high-wage nations, such as Japan, have chosen superior corporate strategies. Lazonick uses a case study of the automobile industry in the United States and Japan to demonstrate that investment in technologies that rely on a broad and deep skill base will lead to more international competitiveness, economic equality, and sustainable prosperity.

For most of the twentieth century the American corporate strategy confined organizational learning to managers. Industries were also characterized by functional and hierarchical segmentation in which managers, workers, and specialists are isolated from one another. In the first half of the century this strategy was successful in making the United States the world's leading industrial power and in bringing greater prosperity to workers at all levels of the firm. However, in the second half, because of the increasingly collective and cumulative character of

organizational learning, firms' success came to require a broad skill base and organizational integration. The concentration of skills at the top and the lack of communication between organizational sectors made successful production difficult.

The integration of Japanese shop-floor auto workers into the organizational learning process (which was fostered by lifetime employment policies) gave firms at least four advantages. First, being able to rely on workers to set up assembly lines for a run greatly reduced set up times, which allowed the firms to produce a wider variety of products more cheaply. Second, giving workers the authority to order parts as needed dramatically reduced carrying and storage costs. Third, allowing worker groups to review and amend quality procedures handed down by superiors created a flow of information from the floor back to engineers that enabled firms to establish better quality procedures at both ends. Fourth, the broad skill base allowed firms to automate their factories more quickly than their American counterparts.

American automobile corporations, meanwhile, kept shop-floor workers outside of organizational learning. Workers were expected to follow procedures imposed on them by those above them in the hierarchical structure. This fostered a confrontational instead of cooperative attitude. Foremen became enforcers rather than the conduits of information that they were in Japan.

> The skill-base hypothesis has many immediate implications. It can explain why U.S. corporations remain innovators while income inequality increases. Lazonick warns that if the skill-base hypothesis is correct, then a change to investment in a broader and deeper skill base is necessary to bring sustainable prosperity to the United States. He suggests a research agenda using case study analysis of corporate strategy and corporate governance to test the skill-base hypothesis further.

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Program Scholars

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

adjusted by macroeconomic policy, are inclined to believe that policy is capable of eliminating the joblessness engendered by labor-saving innovation.

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

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

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

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

economics, preventive medicine, and public affairs at the University of Wisconsin, Madison; she received a Ph.D. from the University of Pennsylvania.

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

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

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

Executive Director **Dimitri B. Papadimitriou,** along with Senior Scholar **L. Randall Wray,** is currently conducting research to assess the effect of demographic shifts--specifically, the aging

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

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

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

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

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

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

Senior Scholar **L. Randall Wray** is currently working on several projects in the areas of aging, employment, and monetary policy. He is studying policies to promote full employment focusing on Hyman P. Minsky's "employer of last resort" proposal and, with Executive Director Dimitri B. Papadimitriou, is conducting research to assess the effect of demographic shifts--specifically, the aging of the population--on the labor market in light of the current slow growth in labor force participation rates and based on different ranges of productivity growth. Papadimitriou and Wray will then evaluate the need to revise public policies concerning the retirement age, the Social Security program, and macroeconomic employment policies. They also will continue their work in the program on restructuring in the financial services sector on the appropriateness of using existing price indexes as targets for monetary policy and will apply their findings to OECD countries.

Wray has been an associate professor at the University of Denver and a Fulbright Research Scholar at the University of Bologna. He received a Ph.D. from Washington University in St. Louis. He is the author of several Public Policy Briefs: with Hyman P. Minsky, Dimitri B. Papadimitriou, and Ronnie J. Phillips, No. 3, *Community Development Banking*; with Papadimitriou and Phillips, No. 6, *A Path to Community Development*, and No. 12, *An Alternative in Small Business Finance*; with Papadimitriou, No. 15, *Monetary Policy Uncovered*, and No. 27, *Targeting Inflation*.

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

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New Working Paper

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

David Alan Aschauer
Working Paper No. 196, July 1997

After the collapse of the Soviet bloc many of the transition economies experienced significant

inflation, largely because their new monetary authorities and undeveloped tax infrastructure induced them to resort to generating revenue through seignorage. In Ukraine inflation rates reached as high as 133 percent per month. Traditional monetary theory holds that raising revenue through money creation causes a simple trade-off: A higher rate of money growth generates higher seignorage, but the associated inflation causes a decline in demand for real cash balances, reducing seignorage. The higher the monetary growth rate, the larger the real balance effect. Therefore, the revenue-maximizing rate of money creation must be realized before the decline in demand for real cash balances becomes the dominant effect. Visiting Scholar David Alan Aschauer cautions, however, that there may be not one revenue-maximizing rate but short and long rates subject to exogenous shocks caused by, for example, changes in inflation expectations.

Aschauer uses quarterly data for the Ukrainian economy from the first quarter of 1993 to the first quarter of 1996 to estimate the seignorage-maximizing level of money creation and the cost, in terms of lost seignorage, of currency stabilization. He estimates a stock adjustment model of the demand for real money balances by regressing real money demand as a function of time, inflation expectations, real output, and the previous quarter's real money balance. The cost of seignorage, then, is a function of the geometric rate of money growth and real money balances.

Using the estimated parameters, Aschauer calculates the revenue-maximizing rate of money growth to be 69 to 81 percent per quarter in the short run and 49 to 50 percent per quarter in the long run. The short-run rate is higher than the long-run rate because of overshooting. Aschauer also estimates the constant money growth levels of inflation, real money balances, and seignorage that would have prevailed had the Ukrainian monetary authority kept money creation constant at its highest level (97 percent per quarter). He finds, surprisingly, that forgone seignorage due to monetary stabilization was rather small, averaging 1.85 percent of GDP per quarter. Seignorage losses caused by other sources were approximately twice as large as those caused by monetary stabilization.

It is possible that Ashauer's low estimate of the cost of monetary stabilization was a result of his assumption that there are no real effects of monetary stabilization. However, real effects could push the estimate either up or down because the effects of increased unemployment and lost output must be weighed against the effects of increased investment due to higher confidence in the currency. Aschauer concludes that the loss of seignorage from monetary stabilization is low enough that the benefits from monetary stabilization likely match or exceed the costs.

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Program Scholars

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

Cambridge University Visiting Scholar **Stephanie Bell** is using Hyman P. Minsky's accounting procedures to analyze Federal Reserve accounting. She is also studying monetary policies for full employment and price stability. She received a B.A. in economics and a B.S. in business finance from California State University at Sacramento and an M.Phil. from Cambridge University

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New Working Paper

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

Robert Forrant
Working Paper No. 199, July 1997

Good, stable jobs with high earnings started to disappear from the U.S. economy in the late 1970s. The loss of the majority of these jobs resulted from structural changes, not cyclical variations in the manufacturing sector of the U.S. economy. Robert Forrant, of the University of Massachusetts Lowell, studies the machine tool industry's role in the decline of the United States's manufacturing base focusing on Japan's ability to surpass the United States in efficient production and the adoption of new technology.

A machine tool is a piece of equipment used to cut, form, bend, or shape metal. It is a "master machine" in that every manufactured product is made by a machine tool or by a machine that was made by a machine tool."[1] The United States dominated world machine tool production in the first half of the twentieth century, but challenges by Japanese and German manufacturers in the 1960s led to what Forrant calls the "stunning collapse" of the American machine tool industry in the 1970s and 1980s. The United States is now a net importer of machine tools and ranks third in production behind Japan and Germany.

According to Forrant, the decline of the machine tool industry was the result of its inability to deal with cyclical demand and its failure to capture the new technology of computer-controlled machine tools (known as numerical control machine tools, or NCs). American producers dealt with highly cyclical demand by allowing inordinate backlogs of work to build up, often taking two or three years to complete an order. This, of course, forced much of the cost of industry fluctuation onto consumers, making the American industry vulnerable to competitors capable of delivering equipment in less time. Japanese firms were able to take advantage of this by focusing on designs with more common parts so that they could fill orders more quickly. Poor R&D by U.S. manufacturers relative to their Japanese counterparts caused the United States to fall critically behind Japan in the manufacture of NCs. In 1979 NCs made up 9 percent of Japanese output and 2 percent of American output; by 1991 the figures had risen 42 percent in Japan but only 7 percent in the United States.

Forrant cites several reasons for the critical American failure in developing new machine tool technologies. First, American machine tool firms were on average smaller than Japanese firms and there was little coordination among them or with the government to take advantage of economies of scale associated with industrywide R&D. As a result, American firms tended to develop competing versions of the same technology, while Japanese firms, with government-sponsored coordination, were quick to develop industry standards. The only government involvement in American machine tool research was related to defense; not only did defense-related research claim a large portion of the R&D budget, but it did not create technology that transferred well to civilian use.

Second, the U.S. machine tool industry lacked cooperation and coordination between producers and users. The needs of consumer products industries drive the demand for new technologies in machine tools. A cooperative relationship helped make the American machine tool industry successful during the first half of the twentieth century, but this coordination deteriorated by the 1970s and 1980s when the industry's major customers both stagnated and began buying machine tools abroad.

Third, U.S. managers pursued a low-skill strategy, hiring inexpensive labor or hiring already trained high-skill labor from other firms, while Japanese firms trained high-skill workers who became lifetime employees. The Japanese also emphasized worker involvement at a time when there was considerable antagonism between management and labor in the United States.

In sum, Forrant finds that the U.S. machine tool industry declined (and therefore the United States lost a considerable number of high-wage jobs) because of the small size of U.S. firms and several management and government mistakes, including lack of coordination among producers and between producers and users, overreliance on a narrow customer base, failure to deal with cyclical demand, and lagging technology research.

Note

1. Max Holland, *When the Machine Stopped: A Cautionary Tale from Industrial America* (Boston: Harvard Business School Press, 1989)

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Program Scholars

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

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

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Program Scholar

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

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New Working Papers

Aggregate Demand, Investment, and the NAIRU

Malcolm Sawyer
Working Paper No. 202, August 1997

The nonaccelerating inflation rate of unemployment, or NAIRU, is generally viewed as a supply-side-determined, short-run equilibrium rate of unemployment. In most NAIRU models, aggregate demand plays no essential role in determining equilibrium unemployment. However, Visiting Scholar Malcolm Sawyer demonstrates that the relationship between the real wage and employment (often mistakenly called labor demand) cannot be fully articulated without reference to aggregate demand. In Sawyer's model, investment shifts the real wage-employment relationship by adding to the capital stock. Therefore, in a sufficiently expansionary environment, the NAIRU can be made compatible with full employment.

The real wage-employment relationship is a set of wage and employment offers determined in an imperfectly competitive market. Its position and shape depend on the cost structure of firms and the level of demand for output, meaning that the relationship cannot be determined without reference to aggregate demand.

It is often assumed that the rates of employment and capacity utilization are closely related and that there is sufficient capacity available for full employment. However, according to Sawyer, this assumption may be unwarranted. If the capital stock is too low to support the available labor force, the NAIRU will appear relatively high. In such a case, a sustained stimulus of aggregate demand can increase the capital stock to stimulate investment, thereby reducing the NAIRU.

This runs counter to the conventional NAIRU approach that any stimulus of demand pushing the unemployment rate below the NAIRU will only cause inflation. Sawyer contends that if pressure on wages can be countered by productivity-enhancing investment, then capacity can be expanded such that any NAIRU is coincident with full employment. However, such an outcome requires a demand policy to stimulate investment to the full employment level.

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The NAIRU: A Critical Appraisal

Malcolm Sawyer
Working Paper No. 203, August 1997

The nonaccelerating inflation rate of unemployment, or NAIRU, has acquired a central role in macroeconomic theory. Fear of inflation has led to a reluctance to allow the unemployment rate to fall below the estimated NAIRU. If so much weight is going to be placed on an estimate of a theoretical variable, it is extremely important to know how valid that theory is and how valid the estimates of that variable are. Visiting Scholar Malcolm Sawyer finds that the mechanism by which an economy would reach a NAIRU has been inadequately specified and that NAIRU models have ignored the role of aggregate demand by implicitly invoking Say's law that supply creates its own demand. He concludes that it is unwise to use the estimated NAIRU as a policy variable unless and until it can be established on stronger theoretical and empirical grounds.

Theoretically, the NAIRU is an equilibrium rate of unemployment that assumes a constant rate of inflation. There are several NAIRU models and in most of them expectations are assumed fulfilled. Most models specify, explicitly or implicitly, that the NAIRU is a unique equilibrium condition determined only by supply-side considerations, in which aggregate demand can have no persistent effects on real variables. The NAIRU is usually claimed to be a strong attracter, that is, the unemployment rate moves quickly to the NAIRU. If it were a weak attracter, unemployment below the NAIRU would be possible, thereby leaving a role for demand-side policies.

Sawyer makes a detailed criticism of two NAIRU models, one by Layard, Nickell, and Jackman (LNJ) and one by Gordon,[1] and discusses the applicability of his analysis to all models. Sawyer's first criticism is that although all NAIRU models (aside from the natural rate of unemployment version) rely on imperfect competition, both the LNJ and the Gordon models fail to address the problem of multiple equilibria, despite the fact that it cannot be ruled out in imperfect competition.

Second, he notes that implicit assumptions must be true for the Gordon model to hold: the unemployment-capacity utilization relationship must be stable, changes in unemployment or capacity utilization must have no effect on wage and price inflation, there can be no error correction mechanism, and the same price index must be relevant for both wage settlements and price determination. Gordon and other NAIRU theorists present little evidence that these assumptions hold, thus casting doubt on the validity of any model relying on them.

A third criticism is that the path of adjustment to the NAIRU is inadequately specified in both models. It is not clear from the assumptions that the economy will move toward rather than away from the NAIRU. The most damaging criticism of all is that the NAIRU makes a new application of Say's law. The natural rate of unemployment hypothesis relies on Say's law in the context of market-clearing equilibrium with no involuntary unemployment. The NAIRU, however, has no market-clearing equilibrium and, therefore, no convincing mechanism by which aggregate demand would adjust to the NAIRU. Sawyer claims that without such an adjustment mechanism, the NAIRU cannot be determined by supply-side factors alone, as is commonly supposed (for discussion of the role of aggregate demand in determining the NAIRU, see Sawyer's Working Paper No. 202). The very concept of a NAIRU is less valuable if it shifts with demand.

All of the above criticisms lead to one conclusion: There is little theoretical certainty about the existence of a supply-side-determined NAIRU. However, this has not stopped economists from attempting to specify empirically an exact value for a NAIRU. The difficulty of estimating the NAIRU adds further uncertainty to policies based on the NAIRU. Estimates of the NAIRU have tended to shift when observed unemployment shifts, and often those movements do not correspond to changes in the factors that are supposed to determine the NAIRU.[2] In light of the theoretical and empirical difficulties with the NAIRU, Sawyer warns that we should not base policy on the NAIRU; we should more fully explore the determinants of the NAIRU, especially aggregate demand.

Notes

1. R. Layard, S. Nickell, and R. Jackman, *Unemployment: Macroeconomic Performance and the Labour Market* (Oxford: Oxford University Press, 1991); R. J. Gordon, "The Time-Varying NAIRU and Its Implications for Economic Policy," *Journal of Economic Perspectives* 11, no. 1 (1997): 11-32.

2. See M. Sawyer, "New Keynesian Macroeconomics and the Determination of Employment and Wages," in R. Rotheim, ed., *New Keynesian Economics: Post Keynesian Alternatives* (London: Routledge, forthcoming).

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Program Scholars

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

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

Kris Feder is an assistant professor of economics at Bard College. Her areas of specialization are public sector eco-nomics and history of economic thought. She received a Ph.D. in economics from Temple University. **Michael Hudson** is a visiting scholar at New York University. He received a Ph.D. in economics from New York University. Feder and Hudson are the authors of Public Policy Brief No. 32, *What's Missing from the Capital Gains Debate*, and with G. J. Miller, of *A Philosophy for a Fair Society,* published by Shepheard-Walwyn.

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Institute News

Immigration Symposium

Senior Scholar Joel Perlmann has organized an academic symposium on immigration and the second generation to be held at the Institute in October (attendance is limited to invited participants). A report on the symposium will appear in the Winter issue of the *Summary*.

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Debates-Debates

Executive Director **Dimitri B. Papadimitriou** participated in a session of the television series *Debates-Debates*. On the question "Is the consumer price index reliable?" Papadimitriou took the "no" position along with Robert Gordon, a professor of economics at Northwestern University, and William A. Niskanen, chairman of the Cato Institute. On the "yes" side were Eugene H. Rotberg, former World Bank vice president and treasurer and a member of the Levy Institute Board of Advisors; Dean Baker of the Economic Policy Institute; and Jeffrey Madrick, editor of *Challenge* and author of *The End of Affluence*.

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

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Research Update: Cambridge University Visiting Scholars

Economics, Politics, and the Role of "Government": An Alternative Cost-Benefit Analysis of Economic and Monetary Union in Europe

Andrew Paulson
July 1997

The European Union (EU) seems to be marching full speed toward monetary union in 1999. Much of the debate surrounding the European Monetary Union (EMU) has centered on details of which countries will be included and how integration will be achieved, but the debate has ignored two fundamental questions: "Is monetary union the best objective for the European Union?" and "Is the Maastricht Treaty the best way to achieve monetary union?"

Cambridge University Visiting Scholar Andrew Paulson concludes that a monetary union without a fiscal union is potentially dangerous and the sacrifices that member states are required to make under the treaty are too harsh. The Maastricht Treaty did not create an authority to assume the powers it requires the member states to relinquish. Such an authority would require a political union, and member states are reluctant to create a federal authority at this time. Paulson warns that without a political union it may be best to wait for monetary union, because monetary union alone could expose the EU to situations that it does not have the institutional power to handle.

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Institutional Investors and Corporate Governance: The Dangers of the "Shareholder Revolution"

David Seddon
August 1997

Cambridge University Visiting Scholar David Seddon studied the effects of the recent "shareholder revolution" on U.S. corporate governance and industrial strategy. No longer concerned with the long-term health of corporations, managers in the United States now seek mainly to maximize short-run shareholder value. At the same time, worldwide corporations are finding that they must move away from a multidivisional, hierarchical corporate structure toward a more integrated, knowledge-intensive structure, such as total quality management (TQM), to succeed in today's marketplace. However, many of the demands of maximizing shareholder value strongly conflict with TQM strategy.

Seddon criticizes both the ethical and theoretical justifications for the shareholder revolution. The ethical argument for shareholder activism is based on four mistaken beliefs. The first is that shareholders own a company. In fact, they own a stake in a company, but do not have many of the rights and liabilities of property ownership. The second is the shareholders are a vital source of capital for corporations. In fact, they have only purchased shares from those who did the original investing. Common stock financed only 5 percent of capital expenditure over the first half of the twentieth century. The third mistaken belief is that shareholders bear all the risk of a corporation's failure. In fact, their liabilities are limited. Employees who invest in firm-specific skills for a company's long-run benefit may not be able to diversify their human capital portfolios, which exposes them to considerable risk if the company fails, while shareholders can

diversify their investment portfolios. The fourth mistaken belief is that maximizing shareholder value benefits a large portion of the population. In fact, the wealthiest 10 percent of the population owns 90 percent of all stocks.

The theoretical argument for shareholder activism is that shareholders, as residual claimants, have the strongest incentive to maximize efficiency. However, what they may have in incentive they lack in focus and expertise. Shareholder activists often advocate reducing employee compensation, reducing the size of the workforce, expanding the authority of lower-level management, and reducing retained earnings. All of these policies conflict with TQM recommendations that a corporation benefits from investing in and cooperating with its employees and reinvesting retained earnings. In short, according to Seddon, the long-term efficiency of a corporation can best be attained when shareholders free management from concern about short-run stock prices and allow managers to manage.

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Russia 1992-1997: A Difficult Place for Foreigners to Make Money? Perceptions and Misperceptions from Abroad

Susannah Rodgers
August 1997

Foreign direct investment in Russia and the other transitional economies of eastern Europe has been exceptionally low. Cambridge University Visiting Scholar Susannah Rodgers contends that there are sound investment opportunities in Russia and that investment would have been higher had not media and academic reports been so discouraging. A feature of the transition in Russia crucial to the investment decision is the lack of reliable information about opportunities and economic and political factors that affect investment success. Despite the newly free press, Russia still lacks a solid media infrastructure and Russians still are reluctant to talk openly.

Despite such problems, Rodgers finds reason for optimism in Russia as long as three improvements are made. First, a reliable information system is essential. Second, the press has to act responsibly in not exaggerating portrayals of Russia as a dangerous place to invest and not publishing stories with little basis in fact that could have a negative influence over investors. Third, academics must tailor prescriptions for economic transition to political realities. Many transition proposals have been too quickly made and have ignored the real political environment.

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