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CONTENTS

Institute News

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Letter from the Executive Director

To our readers:

This issue of the *Summary* includes activities in four research programs and miscellaneous research topics. The employment and labor market structure program includes three new working papers and a *Public Policy Brief*. In one working paper, Resident Scholar Oren M. Levin-Waldman contends that current arguments for and against raising the minimum wage miss the point because they do not focus on the long-term effects of raising the minimum wage, which could include raising productivity levels. In one of two working papers by Senior Scholar Joel Perlmann, he argues that assimilation cannot be studied as an outcome alone, but should be viewed as a process, aspects of which are important in their own right. In the second, Perlmann explores explanations for Russian Jewish immigrants' entry into trade by examining data on their occupational experience in their country of origin. In *Public Policy Brief No. 28*, Making Work Pay, Barry Bluestone and Teresa Ghilarducci argue that under current conditions of income instability and rising adult poverty, it is necessary to establish a "wage insurance" system to assure that people who work will not be mired in poverty and dependence.

Activities in the federal budget policy program include three new working papers by Resident

Scholar Neil H. Buchanan and an episode of the television show *Debates-Debates*. The first two papers are an examination of alternative definitions of the federal budget deficit to determine if these definitions improve the results of econometric studies that use the deficit as an exogenous variable. The third paper is an analysis of a number of tax proposals in terms of their effects on the budget deficit, different groups of taxpayers, and taxpaying households as a whole. The topic of the *Debates-Debates* episode was the Dole tax plan.

The financial sector restructuring program includes a new working paper in which Distinguished Scholar Wynne Godley presents a formalized stock-flow model that takes place in historical time and under conditions of uncertainty and incorporates a role for the financial sector in providing funding for both capital investment and firm operations, should expectations prove false.

The international trade and competitiveness program is represented by a seminar by Eugene Dattel in which he argued that recent crises in the Japanese financial sector are not isolated events, but symptoms of structural flaws in Japanese financial institutions.

Work under miscellaneous research topics includes a working paper, a workshop, and an episode of *Debates-Debates*. In the working paper, Senior Fellow Walter M. Cadette lays out the case for transforming the current method of financing health careemployment-based health insurance with tax-excluded premiumsto one that provides an income-scaled tax credit with which all individuals would purchase comprehensive coverage. The topic of the workshop was the future of the welfare state. Participants at the workshop included Lawrence Mead, New York University; Howard Rosen, Competitiveness Policy Institute; Howard Karger, Graduate School of Social Work at the University of Houston; David Stoesz, Virginia Commonwealth University; and Michael Sherraden, George Brown School of Social Work, Washington University in St. Louis. The *Debates-Debates* topic was the economics of aging.

This issue of the *Summary* also includes a note on the passing of Hyman P. Minsky, a Levy Institute distinguished scholar and a member of its Board of Advisors. Hy will be remembered both as a guiding force for Levy Institute research, particularly in the financial sector restructuring program, and as a beloved member of the Levy Institute family. We also wish to welcome Alan S. Blinder on his return to the Board of Advisors.

This issue of the *Summary* concludes with a list of our recent publications.

As always, I invite your comments on the Summary.

Dimitri B. Papadimitriou
Executive Director

New Working Papers

The Minimum Wage and the Path toward a High-Wage Economy

Oren M. Levin-Waldman
Working Paper No. 166, June 1996

According to Resident Scholar Oren M. Levin-Waldman, the arguments both in favor of raising the minimum wage (to restore its real spending power to levels of previous years, to increase the incentive to work, and, as a matter of fairness, to allow those who work to earn incomes above the poverty line) and against raising the minimum (displacement effects resulting in lower levels of employment) both have merit, but ultimately "miss the point" because their focus is too narrow. They concentrate on how a change in the wage floor would affect one segment of the labor market (those at the bottom or teenage workers, for example) and not on how it would affect the market as a whole. Moreover, because findings on the short- and intermediate-term effects of a change in the minimum wage are inconclusive, discussion should focus on the long-term effects of raising the minimum wage, which could include raising productivity levels.

The arguments for and against a higher minimum wage boil down to whether the U.S. economy should follow a low-road/low-wage or high-road/high-wage growth path. A low-road strategy involves developing an economy based on mass production, with large numbers of workers hired for low-skill jobs at low wages. A high-road strategy involves developing an information-based economy, which would require a flexible workforce with a high level of skills; such workers would, of course, command higher wages. (They could obtain the necessary skills through education and training programs.) Levin-Waldman contends that following a high-road path would raise productivity. Therefore, the standard neoclassical labor market argument should be "stood on its head" and firms should be pushed toward a high-road path. Legislating an increase in the minimum wage would contribute to accomplishing this task. Redesigning the welfare system so that it goes beyond income maintenance to include boosting the perceived value of work would be another important step.

Assimilation: The Second Generation and Beyond, Then and Now

Joel Perlmann and Roger Waldinger
Working Paper No. 168, June 1996

Assimilation of today's immigrants is one topic in the current debate on immigration. Some observers assert that recent immigrants are unable to assimilate into U.S. society as easily as past immigrants were able to. Others counter that the pressures against assimilation today are not strong. In this working paper, Senior Scholar Joel Perlmann and Research Associate Roger Waldinger, professor of sociology at the University of California at Los Angeles, argue that assimilation cannot be studied as an outcome alone, but should be viewed as a process, aspects of which are important in their own right.

Perlmann and Waldinger explore how outsiders become insiders and the social closure, or exclusion, strategies that insiders pursue. The authors compare first-generation Jewish youths around 1920 and Asian youths around 1980 who sought admission to U.S. colleges and universities. When the share of Jewish youths at these institutions began to swell, a backlash occurred and deliberate policies to limit the enrollment of this group were adopted, especially at the elite colleges and universities. These policies were not reversed until laws were passed against discrimination based on race or religion in higher education. Sixty years later, the experience of Asian immigrant youths was different. By 1980 resident Asians had developed some political clout and had established social organizations that could be mobilized around the issue of discrimination. The acculturation of Jewish youths had proceeded rapidly because of the speed with which they acquired education and skills, yet structural assimilation had proceeded more slowly because of exclusionary practices. Because of the earlier struggles of the Jews against discrimination and because of the Asians' political clout, the Asians had more leverage within the institutions that had at one time discriminated against the new group.

Perlmann and Waldinger then focus on race, stating that for past immigrants race was a social construct, not a definition based only on skin color and other physical attributes. Southern and eastern European immigrants were originally considered racially distinct from assimilated American groups, who considered themselves "white." However, as the southern and eastern Europeans assimilated, they eventually came to be defined as white and to adopt the social closure strategies that maintained black exclusion. Speculating on how the process of racial definition may be working today, the authors offer two scenarios, one pessimistic and the other optimistic. The pessimistic scenario projects a divide between blacks and all others, with perhaps a term to replace white that can include Asians and Hispanics. The optimistic scenario rests on the evolution of black-white relations in the direction of more equality.

Because social mobility is a key feature in the process of assimilation, Perlmann and Waldinger ask what the prospects of mobility for present immigrants are if low-skill manufacturing jobs, which were crucial to mobility for past immigrants, are disappearing. Historical studies of mobility tend to show that ethnic differences remained important in the economic standing of groups into the second generation; ancestry, or outcome, studies show that these differences eventually disappeared. The authors note that the socioeconomic prospects of those entering at the bottom may be worse now than in the past because of labor market transformations. However, jobs in the service sector may serve the same function that low-skill manufacturing jobs served for past immigrants. Another aspect of economic change that may make mobility more difficult for today's immigrants is increasing income disparity.

Acculturation of the second generation involves convergence with both the cultural patterns and the economic standards of mainstream society. In the study of assimilation, an important question is whether the experience of past and present second generations is similar or has changed because of a mismatch between second-generation economic expectations and labor market realities. According to Perlmann and Waldinger, evidence implies that a second-generation revolt, or "oppositional culture," can emerge without exposure to visible and stigmatized native-born minorities, which points to a continuity of experience between past and present children of immigrants. The authors note that a discussion of class is missing from the current debate.

Perlmann and Waldinger's final point in this review of aspects of the process of assimilation is that the process differs under conditions of replenishment and under conditions of nonreplenishment, but the differences may be smaller than many observers think.

Selective Migration as a Basis for Upward Mobility? The Occupations of the Jewish Immigrants to the United States, ca. 1900

Joel Perlmann
Working Paper No. 172, October 1996

The upward mobility of Jews who migrated to the United States at the turn of the nineteenth century has been explained as a function of premigrational cultural characteristics (such as a tradition of learning) or premigrational structural attributes (skills in certain industries and occupations that could be applied in the new country). In this working paper, Senior Scholar Joel Perlmann does not discount either of these explanations, but suggests that more attention should be paid to the rapid rate of entry of Jews into trade.

The entry of Jews into trade upon coming to the United States could be explained several ways, for example, they had prior experience and knowledge garnered while employed in a specific occupation (such as in the garment industry), which provided a background for work in trade, or they had prior experience or knowledge about trade itself. In examining the relative importance to mobility of a background in manufacturing versus a background in trade, Perlmann finds that Jewish immigrants in manufacturing were overrepresented and those in trade underrepresented compared to the population in the country of origin.(1) Such selectivity will have an effect on the strength of the argument that upward mobility was a result of commercial experience. Perlmann, using immigration data that only recently have become available, examines this selectivity by comparing the occupations of Russian Jewish immigrants to the occupations of the base population from which they came, that is, the Jews in the Russian Pale of Settlement. He uses Russian and U.S. data, focusing on detailed data from the 1897 Russian Census and data on Jewish immigrant arrivals at the Port of New York from 1899 to 1900 and from 1907 to 1908 (now available at the individual immigrant level by country of origin, gender, age, occupation, etc.). Perlmann also considers whether information reported by immigrants was inaccurate due to misunderstandings or deception.

Perlmann finds that Jews who migrated to the United States from the Pale came primarily from seven provinces and that these provinces had a distinct occupational structure (a greater proportion employed in handicrafts than in commerce) and were experiencing slow economic growth. In addition, immigrants were disproportionately younger than the overall Jewish population from which they came. After adjusting for regional and age variations and making separate comparisons for each gender group (see Exhibit 1), Perlmann finds that although the adjustments reduce the degree to which trade is underrepresented among immigrants (because the percentage of those occupied in trade in the provinces from which most immigrants came was lower than in the Pale as a whole), they cannot explain the remaining degree of underrepresentation among immigrants of those employed in the trade occupations (28 percent in the Pale versus 11 percent of immigrants to the United States).

What, other than selective migration, might explain the variations in occupational representation among immigrants? Did immigrants lie about their occupation upon entry to the United States? Did the method of reporting change from one year to the next? Did immigrants report the occupation they had practiced in their country of origin or the occupation into which they wished to gain entry upon arrival?

To answer these questions, Perlmann first examines the claim that immigrants misreported their occupation. He then takes a closer look at the data; he examines the passenger list data for internal reporting consistency over time, checks the consistency of this source with another source at that time (the U.S. Immigration Commission *Reports)*, and compares the passenger list data to reports on stated occupations among the same population at a later time (the 1910 U.S. Census *Public Use Microdata Samples* [PUMS]). The passenger list data appear to be internally consistent, at least for male occupations. However, the occupational mix taken from the passenger list data does not appear to be consistent with the data of either the Immigration Commission or the Census, while those two sources are more consistent with each other. The Immigration Commission and Census data indicate that Jewish immigrants working in manufacturing in the United States had at least some prior experience in trade in their native country, which lends some credence to the structural idea that the upward mobility of Jewish immigrants in trade was at least in part the result of prior skills in trade itself (rather than that their work in manufacturing provided Jewish immigrants with the basis for entering trade). Perlmann notes that the passenger list data and other data cannot be easily reconciled. A simple way to deal with the disparity would be to assume that the passenger list data are incorrect despite their internal consistency for male immigrants. If this hypothesis is not accepted, the inconsistency of the data sets still requires reconciliation.

Note

1. For example, Kuznets reports that 63 percent of Russian Jewish immigrants arriving between 1988 and 1902 were occupied in manufacturing and mechanical work, while only 38 percent of employed Russian Jews were so employed in 1897. However, immigrant commercial workers represented 7 percent of the total Jewish immigrant population, while 31 percent of Russian Jews were employed in such work (Simon Kuznets, "Immigration of Russian Jews," monograph, 1975, Table XI, rows 4 and 6).

New *Public Policy Brief*

Making Work Pay

Barry Bluestone and Teresa Ghilarducci
***Public Policy Brief* No. 28, October 1996**

In this *Public Policy Brief*, Barry Bluestone and Teresa Ghilarducci argue that the current environment of stagnating wages, increasing income instability, and rising adult poverty makes a program of "wage insurance" necessary to keep the working poor above the poverty line. The War on Poverty succeeded in reducing the elderly poverty rate from 30.0 percent to 10.5 percent over the past three decades. Nonelderly adults made up an absolute majority (50.2 percent) of all poor persons in the nation in 1994, up from 40.1 percent. With the overall growth in the number of persons in poverty in the United States from 25.4 million in 1970 to 38.1 million in 1994, the number of poor nonelderly adults nearly doubled, from 10.4 million to 19.1 million.

The recent modest increase in the minimum wage to $5.15 will raise the income of over 12 million workers who now earn between $4.25 and $5.14 per hour. Moreover, findings suggest that nearly 9 million workers currently earning between $5.15 and $6.14 per hour will see their wages rise by an average of 10 percent when the $5.15 wage floor goes into effect. This means that more than 21 million workersone out of six in the workforcewill see their wages improve as a result of enacting the higher minimum wage.

Bluestone and Ghilarducci note that essential components of a wage insurance system already exist in the earned income tax credit (EITC) and the minimum wage. But the EITC and the federal wage floor must be seen as complements to, not substitutes for, one another. Together, these components would meet criteria important for any insurance program: high target efficiency and minimal adverse behavioral effects. Properly used, the considerable strengths of the EITC offset weaknesses in the minimum wage, while the minimum wage's greatest benefits offset some of the shortcomings of the EITC.

The EITC's greatest asset, from the perspective of battling poverty, is its target efficiency. More than 46 percent of the total tax credit goes to families who are living at the official poverty line, and more than two-thirds of the credit goes to families with income under $20,000. The EITC has still another advantage, one that is often overlooked by both its supporters and its detractors: It is a form of wage insurance for the temporary poor in an era of job instability and earnings insecurity. In any single year about one in six families is eligible for the tax credit, and over a period of a decade nearly 40 percent of families will have a year or more in which their wage income declines sufficiently for them to be eligible for the EITC.

On three criteria (income adequacy, target efficiency, and labor demand employment effects), the minimum wage is weak. These are precisely the strengths of the EITC. On four other criteria (labor supply employment effects, productivity enhancement, minimal fiscal impact, and limited moral hazard), the minimum wage is clearly the preferred program. What makes the two fit together so well is that the existence of a higher minimum wage actually reduces the negative productivity, fiscal impact, and moral hazard effects of the EITC, while the EITC makes up for the weak target efficiency and weak income adequacy of the minimum wage.

Bluestone and Ghilarducci argue for a comprehensive and coherent strategy aimed at the working poor and those susceptible to highly fluctuating incomes. Changes in the food stamp program enacted as part of the recent welfare reform legislation and proposed cuts in the EITC work in precisely the opposite direction. A cut of $23 billion in food stamp benefits between 1997 and 2002 and the increased FICA tax liability accompanying the increase in the federal minimum wage reduce the effective hike in the wage floor from $0.90 to $0.73 per hour for nonimmigrants. For legal immigrants working full-time, who will now be denied food stamps, the lost benefit is more than double the earnings gain attributable to the increase in the minimum wage. In addition, the congressional resolution for balancing the federal budget by 2002 includes an $18.5 billion reduction in EITC benefits. These changes undermine the objective of assuring that families that work will not be mired in poverty and dependency.

In part as a result of corporate downsizing, an increasing number of once-secure working-class and middle-class families are experiencing temporary or periodic poverty. Falling wages for at least the bottom 20 percent of the workforce and rising job and wage instability for much of the middle class portend a society in which work no longer serves as an effective guarantee against privation. Institutionalizing a form of wage insurance based on the EITC and a rising minimum wage can help protect a large segment of workers in this economic environment. Efforts to improve education and training programs, expand community development efforts, promote unionization, and narrow the gender pay gap can reduce the long-run cost of wage insurance.

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 answer 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 teaches at the Graduate School of Management and Urban Policy of the New School for Social Research and is a research associate at the C. V. Starr Center for Applied Economics at New York University. He received a Ph.D. in economics from the New School for Social Research.

Continuing the work he conducted while a visiting scholar, Research Associate **Takao Kato** is examining the relationship between human resource management practices (HRMPs) and productivity. In his current research he is examining interactions between various human resource policies in Japanese firmssuch as employment stability, investment, and collective bargainingand economic performance. Because much of the discussion concerning economic and business policies in the United States compares its domestic policies with those of Japan, an investigation of Japanese business may provide insights into changes in domestic policies that would enhance performance. Kato, associate professor of economics at Colgate University, received a Ph.D. in economics from Queen's University, Kingston, Ontario. He is the author of *Public Policy Brief* No. 19, *Cooperate to Compete*.

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. Levin-Waldman's research, which overlaps work being conducted in the Levy Institute's federal budget policy research program, also includes an examination of worker displacement due to plant closures. In particular, he is evaluating the effectiveness of the 1995 federal plant closing law in protecting workers and facilitating labor market adjustments. If the legislation represents a step in a process that will lead to a comprehensive national employment policy, it will have repercussions with respect to the overhaul of the current unemployment insurance system. Levin-Waldman is the author of *Public Policy Brief* No. 21, *The Consolidated Assistance Program* and *Public Policy Brief* No. 26, *Making Unemployment Insurance Work.* His book *Reconceiving Liberalism: Dilemmas of Contemporary Liberal Public Policy* is due to be published by the University of Pittsburgh Press. Levin-Waldman received a Ph.D. in political science from Temple University.

Executive Director **Dimitri B. Papadimitriou** and Research Associate **L. Randall Wray** currently are conducting research to assess the effect of demographic shiftsspecifically, the aging of the populationon 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 financial sector restructuring program on the appropriateness of using existing price indexes as targets for monetary policy, as discussed in *Public Policy Brief* No. 27, *Targeting Inflation*, 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. Wray is an associate professor of economics at the University of Denver. He received a Ph.D. in economics from Washington University in St. Louis. Papadimitriou and Wray also are the authors of *Public Policy Brief* No. 15, *Monetary Policy Uncovered*.

Senior Scholar **Joel Perlmann** is guiding a research initiative entitled "Ethnicity and Economy in AmericaPast 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 East 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 East 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.

New Working Papers

Comparing Alternative Methods of Adjusting U.S. Federal Fiscal Deficits for Cyclical and Price Effects

Neil H. Buchanan
Working Paper No. 169, June 1996

In this working paper, Resident Scholar Neil H. Buchanan statistically tests six alternative definitions of the federal budget deficit to determine if these definitions improve the results of econometric studies that use the deficit as an exogenous variable. Buchanan wishes to (1) evaluate Robert Eisner's conclusion that a price-adjusted deficit definition improves econometric results and (2) compare alternative measures of the deficit.

Buchanan's analysis begins with two definitions of the structural deficit published by the government: the Bureau of Economic Analysis's high-employment deficit, which is based on a constant standard of unemployment, and the Congressional Budget Office's standardized employment deficit, which is based on a varying standard of unemployment, namely, the NAIRU.(1) He then compares two sets of price-adjusted structural deficit measures to the set of original definitions. Each original definition is adjusted by using two different calculations of a price effect intended to gauge the change in the value of outstanding government debt. One set of price-adjusted measures is obtained by subtracting the product of the year-end par value of outstanding debt and the annual rate of inflation from each of the original measures of structural deficit. The second price-adjusted set is obtained by subtracting a more complex derivation of a price effect, namely, one that accounts for the timing of inflation's effect on prior debt.(2)

The results of initial regression analysis indicate that the method of adjusting for price effects is more important than the method of adjusting for cyclical effects. Using a variety of specifications, time periods, and data definitions, Buchanan's findings did not support the case that deficit spending stimulates GDP growth. However, a relationship was found between unemployment and the deficit, even when the nonprice-adjusted measures of the deficit were used. The results of regressions using shorter (15-year) periods show a decline in the importance of price adjusting and a further weakening of the growth-deficit relationship compared to what was found in the initial regressions. The unemployment-deficit relationship, however, was stronger than in the full-period regressions.

Notes

1. If Okun's law holds and if the relationship between the GDP and deficits is linear, then the two series should show roughly the same variance. Buchanan notes, however, that research indicates that the high-employment standard has shifted in recent decades, resulting in the failure of Okun's Law (Stephen K. McNees, "How Fast Can We Grow?" *New England Economic Review*, January/February 1991, pp. 34). As a result, a shifting high-employment standard would imply different time-series econometric results for the two series, making it necessary to examine both definitions.

2. The more complicated method of determining the price effect was derived in Robert Eisner and Paul J. Pieper, "A New View of the Federal Debt and Budget Deficits," *The American Economic Review*, March 1984, pp. 1129.

Which Deficit? Comparing Thirteen Measures of the U.S. Fiscal Deficit on Theoretical and Empirical Grounds

Neil H. Buchanan
Working Paper No. 170, June 1996

For some time economists have acknowledged that reported budgetary data do not necessarily reflect actual economic activity. Agreement has not been reached, however, on how budget figures should be adjusted to reflect such activity accurately. In this working paper, Resident Scholar Neil H. Buchanan examines 13 alternative measures of the budget deficit in order to determine which, if any, are theoretically or statistically sounder than existing measures. He evaluates them in terms of their theoretical value, that is, their ability to capture benefits (such as higher levels of employment [subject to NAIRU constraints], higher rates of growth, and higher levels of private investment), and costs (higher rates of inflation and lower levels of private investment, consumption, and net exports) to the economy. He also tests whether the new definitions provide empirically more robust estimates than existing measures.

Different measures can provide somewhat different gauges of the total macroeconomic effects of deficit spending. For example, since spending by any level of government has macroeconomic effects, it can be argued that all spending, not only that of the federal government, should be included in the derivation of the "government deficit." Some assert that the so-called inflation tax (the effects of inflation on changes in interest rate payments) should be subtracted from the deficit since inflation results in a decrease in the real amount of debt outstanding. An argument also can be made that changes in spending and revenues resulting from a change in the business cycle should be smoothed over the course of the business cycle. Another adjustment would separate government expenditures for capital items from expenditures for consumption items because capital items yield long-term returns. In addition, however, government's long-term liabilities in the form of, for example, unfunded loan and pension guarantees, should be accounted for in the definition of a capital budget.

The 13 alternative measures that Buchanan examines cover a number of variations of these suggestions. He begins by contrasting the nominal on-budget deficit to the nominal unified federal deficit (which includes off-budget spending) and a measure that includes state and local expenditures. Two measures adjust for changes in government debt (one includes state and local spending). Four measures adjust for cyclical changes in the economy (the structural deficit) with estimates based on the NAIRU; the structural deficit is estimated with and without adjustments for price effects on outstanding debt and with and without state and local spending. Finally, four measures separate capital spending from spending on current-term items. Two of the capital-adjusted measures account for liabilities (measured as the unfunded liabilities of the Social Security trust fund), with one including state and local spending. One of the two measures without liabilities also includes state and local spending.

Buchanan states that the arguments for and against deficit spending can be reduced to one question: Does such spending prevent similar transactions from occurring in the private sector? Buchanan states that crowding out arguments are the only supportable arguments against deficit spending.(1) Only one deficit measure, thenthe price-adjusted structural measure that includes state and local spendingis theoretically sufficient to determine the extent to which total benefits and costs result from deficit spending. Net harms can then be assessed using either of the capital-adjusted measures (that is, with or without liabilities) that include state and local spending.

Buchanan's quantitative analysis includes (1) basic statistics (maximum, minimum, mean, and standard deviation) of the estimates of the 13 deficit measures, both as raw numbers and as percentages of nominal GDP; (2) two correlation matrices, one that includes the 13 deficit measures and the other the change in the measures; (3) results of regression analyses of four equations; and (4) estimates for 13 vector autoregressions (VAR) and corresponding impulse response functions.

The most remarkable of the basic statistics were the standard deviations for the two measures that included adjustment for unfunded liabilities. The estimated maximum deficit according to these two measures was more than $4 trillion (compared to a high of $340.5 billion among the other 11 measures), while the estimated maximum surplus was more than $3 trillion (compared to a high of $172.29 among the other 11 measures). The correlation matrices showed that adjusting for structural deficits introduces the largest divergence in the variables. The measures that include adjustment for capital spending including liabilities are almost entirely uncorrelated to the other series. The first of the four regression equations was designed to test the effect of the deficit on inflation; the second, the effect on unemployment; and the third and fourth, the effect on GDP growth.(2) The strongest measure using only federal data was the structural measure adjusted for price effects on outstanding debt.(3) The results from estimates using data including state and local expenditures, however, were less clear-cut, although the structural deficit measure adjusted for capital spending and adjusted for price effects performed as well or better than the similar measure not adjusted for capital spending. Overall, the results showed no consistent advantage to using measures that included state and local spending data in their derivation.

Buchanan concludes that there is a "disappointing divergence" between alternative measures of the deficit that are theoretically most robust and those that yield the best empirical results. Careful adjustment for cyclical and price effects generally improves the statistical explanatory power of measures using only federal spending data. Other measures can still be used to determine if we are running a deficit and to point out the fact that deficit spending is not, in and of itself, a bad thing.

Notes

1. Buchanan notes, however, that "if the spending is financed by central bank purchases of government debt, a separate set of monetary theory issues is raised."

2. Estimates were derived using ordinary least squares (OLS), a vector autoregressive (VAR) method, and an instrumental variables (IV) method (each using separate estimates). Separate regressionsusing contemporaneous values and lagged values of the deficit variablewere derived using both OLS and VAR methods. The estimates using the IV equations were made using both an extensive and a limited set of instruments.

3. Strongest in the sense that it "dominated 13 of 24 panels, . . . 11 of 16 OLS regressions, and 7 of 8 lagged and limited IV regressions."

A Critique of Competing Plans for Radical Tax Restructuring

Neil H. Buchanan
Working Paper No. 173, October 1996

At almost any time there exists a plan to alter the structure of taxation, and the number of such plans seems to increase during election years. In this working paper, Resident Scholar Neil H. Buchanan analyzes a number of tax proposals in terms of their effects on the budget deficit, on different groups of taxpayers, and on taxpaying households as a whole.(1) He groups the tax plans into three general categories: simplifying payment of income taxes, switching to a value-added tax system,(2) and altering the current taxation of savings or labor incomes. The tax plans Buchanan examines are the Gephardt plan, the Lugar plan, the USA Tax plan, the Armey-Shelby flat tax plan, and flat tax proposals in general.

Synopsis of the Plans

The plan proposed by Representative Richard Gephardt (D-Mo.) imposes a 10 percent tax on all types of income, with the marginal rate increasing for incomes above $59,950 (gross income for a family of four) to a top marginal rate of 34 percent. All deductions except the home mortgage deduction are eliminated.

The plan proposed by Senator Richard Lugar (R-Ind.) repeals the entire tax code and replaces it with a 17 percent national sales tax on the purchase of all final goods and services.

The USA Tax plan, proposed by Senators Sam Nunn (D-Ga.) and Pete Dominici (R-N.Mex.), is a savings-exempt plan that allows unlimited funds to be put into savings, with tax payments levied only when those funds are withdrawn. The deduction for state and local taxes is eliminated, but higher education costs are treated as an "expensable investment" rather than as consumption and a deduction for payroll taxes is allowed. Taxes are imposed at rates of 15, 20, and 40 percent; deductions and credits, however, reduce effective rates to 11, 19, and 32 percent. Businesses pay a flat 11 percent rate on net cash flow.

The plan proposed by Representative Richard Armey (R-Tex.) and Senator Richard Shelby (R-Ala.) eliminates all deductions and replaces them with high personal exemptions, with the remaining income taxed at a flat rate of 17 percent. Only labor income is subject to the tax. Business taxes are levied on net cash flow at a rate of 17 percent, with investment costs fully expensed in the year they are incurred.

Flat tax proposals in general are based on the plan proposed by Professors Robert Hall and Alvin Rabushka of the Hoover Institution.(3) These proposals exempt earnings from savings from taxation and tax all the remaining income at a single, flat rate. Proponents of flat tax plans assert that generous exemptions can preserve some progressivity in the tax structure. Hall and Rabushka claim that by lowering the "cost of saving," a flat tax would result in lower interest rates. Buchanan notes that these plans are problematic in that they do not state how financial services, which are in the business of handling large cash flows, would be taxed.

Analysis of the Plans

According to Buchanan, all of the plans examined here fail to recognize that the federal income tax is but one component of the federal tax system and the federal tax system is but one component of the overall tax system and that it is impossible to devise a tax system that does not distort the economy in some manner. The large number of taxing jurisdictions nationwide and their interactions with the federal system make it difficult to devise a federal system that is both simple and efficient. For example, a tax plan must take into account the regressive nature of the Social Security tax system. Buchanan asserts that, in view of the regressivity of certain components of the tax system, the goal of a new tax structure should be to make the federal tax system as or more progressive than it is today.

Buchanan explains that no tax system can be free of distortionary effects. He notes that proponents of the flat tax are wrong when they assert that such a tax would not change preferences with respect to trade-offs between any set of goods because they are ignoring income effects and possible changes in labor-leisure choices.

According to Buchanan, economic policy should focus on creating both long-term and short-term prosperity and this is most easily accomplished when there is a degree of flexibility in policy making. Therefore, plans that have supermajority requirements for changing the tax code (such as the Gephardt plan) should be avoided. Moreover, some flat tax plans (such as the Kemp Commission plan) have the supermajority requirement for the rate, but not for the standard deduction, and changes in the deduction would affect the progressivity of a flat tax system.

Buchanan notes the transition from one system to another will have serious consequences for some individuals. For example, it has been estimated that elimination of the home mortgage deduction would result in a drop of 15 to 20 percent in the real value of residential real estate. This implies not only that the total value of the asset would decline by that amount, but that people who held less than 15 to 20 percent equity in their home would lose their entire stake. A transitional effect of switching from an income to a consumption tax raises the issue of "general fairness" to workers at or near retirement age. These workers, after having paid into a system of income taxes, would be subject to consumption taxes just when they are becoming "heavy consumers."

Proponents of some plans assert that their plan would reduce the complexity of the current system. Buchanan argues that "while these and other issues are important in their own right, they are simply arguments for `some kind of change' rather than arguments for any specific alternative." He claims that oft-heard estimates of a $300 billion cost of complying with the current tax system "stretch credulity." Moreover, the current 1040EZ form has only 12 lines and accounts for more items (such as the EITC, taxable interest income, and unemployment compensation) than the simpler "postcard-sized" forms that have been promoted by advocates of tax simplification. Finally, however, simplicity does not in itself provide justification for the substance contained in any of the plans, such as the elimination of tax brackets or the exemption of savings from taxation.

Buchanan concludes that all of the plans currently being considered suffer from significant shortcomings, such as "speculative" revenue effects and claims of economic neutrality. In addition, some place unwise limitations on future fiscal policy actions and create significant problems in the transition to the new system. A better policy would be to make the existing system work better. Buchanan rates the Gephardt plan as the "most judicious and sensible."

Notes

1. Buchanan does not think it is necessary to analyze how the tax proposals might affect capital investment. He cites research indicating that capital investment does not respond to changes in the cost of capital and that the tax burden on capital in the United States is comparable to that in two of the United States's major competitors, Germany and Japan. Moreover, theoretical work that extends the basic neoclassical model to include risk and uncertainty or preferences for current versus future consumption yields ambiguous results about how a change in tax rates on capital will affect capital development. In addition, he leaves questions relating to the effect of tax changes on the distribution of income to a separate paper (forthcoming).

2. Although a value-added tax may take several forms, only a national sales tax is considered here.

3. Robert H. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, Calif.: Hoover Institution Press, 1995).

Debates-Debates

The Dole Tax Plan

The topic of a recent segment of the PBS television program *Debates-Debates* was the tax plan advocated by Senator Robert Dole during his presidential campaign. Those arguing that the plan could work were **Ed Rubenstein,** economics writer for *National Review;* **Bruce Bartlett**, senior fellow at the National Center for of Policy Analysis and member of the Treasury Department during the Reagan administration; and **Dan Mitchell**, senior fellow at the Heritage Foundation and moderator of the WNET television program *Mitchells in the Morning*. Those arguing that the plan could not work were **Robert L. Kuttner**, *Business Week* columnist and co-editor of *The American Prospect*; **Robert I. Eisner**, professor of economics at Northwestern University, whose most recent book is *The Misunderstood Economy*; and Levy Institute Executive Director **Dimitri B. Papadimitriou**. Those who favored the plan argued that its tax cuts would raise income levels, stimulate economic growth, and reduce an overly heavy tax burden. Those arguing against the plan asserted that the tax cuts would widen the distribution of income and increase the deficit.

Effect on Income Distribution

Rubenstein expressed his belief that the Dole tax plan was needed to raise income levels, especially those of the poor. After-tax incomes are lower now than they were at the end of the last recovery and the poor have gotten poorer. During the 1960s and 1980s tax cuts resulted in a rise in the real incomes of the poor; today, nearly seven years after the beginning of the current recovery, those needing help still lag behind.

Kuttner asserted that the tax cuts in the Dole plan would benefit not the poor but the upper 1 percent of the population. Papadimitriou agreed, stating his belief that the plan is regressive. When the benefits of the capital gains tax are included, the plan is even more highly skewed in favor of those making over $100,000 in average annual earnings. Further, similar cuts enacted in the 1980s resulted in a wider distribution of income, an increase in the debt load from $906 billion to $2.6 trillion, and a decline in the saving rate from 8.2 to 4.8 percent.

When questioned on the tax increases of 1993, Kuttner defended them on distributional grounds, noting that people in the highest income bracket could not be hurting much, in view of current conditions of rising productivity, a growing stock market, and improving housing values. Kuttner was asked whether imposing high taxes on the rich was the best way to lift the economic condition of the poor. (Rubenstein claimed there is a 52 percent marginal tax rate on the rich, when state and local taxes are included.) Kuttner replied that, given the loopholes in the system, those at the upper boundary of the income scale rarely pay the highest nominal rate, but a progressive graduated tax code is not a solution, merely one policy among many to combat the problem. The weakness of the whole supply-side view is that it assumes that individuals' behavior is determined solely by the tax code. The economy is much more complicated, however.

Papadimitriou was asked to explain why, even though both President Bush and President Clinton raised taxes on the rich, the rich have gotten richer and the poor have gotten poorer. Doesn't that suggest that higher taxes on the rich are not good for the poor? Papadimitriou did not agree, stating that a tax cut implemented while maintaining a balanced budget must necessarily be regressive. If a balanced budget is removed as a condition, it would be possible to cut taxes and target policies at the working poor that would alter the distribution of income.

Rubenstein defended cutting the capital gains tax rate on the grounds that doing so would "unlock a tremendous reservoir of income that is withheld from taxation." Although there is a concentration of wealth, when the rich get richer, the economy grows fast enough so that the benefits of such gains "percolate" to the poor. He asserted that evidence from the 1980s makes it clear that the Dole tax plan would benefit the poor. During that period the bottom 20 percent in the income distribution experienced an increase in their after-tax incomes, primarily because those who had previously not had a job were able to find work. In addition, the poverty rate in 1989 was lower than the rates in 1982 and 1983.

Mitchell stated that even with the Dole tax cuts, government would be $200 billion larger in 2002. He asked Papadimitriou whether it was then a bad thing to limit the growth of the government sector to, say, 2 percent per year even if inflation was rising by 3 percent? Papadimitriou stated his misgivings about these estimates, noting that they were the result of dynamic scoring methods. Of greater concern, however, is the fact that such tax cuts implemented in the past have resulted in a more highly skewed distribution of income and wealth. During the 1980s, for example, tax revenue growth did not outpace income or wealth growth. Moreover, under the Dole plan, taxpayers in the 15 percent tax bracket, for example, would experience a smaller effective tax cut than the plan's 15 percent rate because they would likely lose some benefits of the EITC. Under these circumstances, limiting the size of government would come at the expense of those who would most need government assistance.

Effect on the Deficit

Mitchell asserted that the tax cut could be enacted and the budget still balanced by the year 2002 as long as spending growth is limited to 2.1 percent per year. Moreover, he claimed that tax cuts enacted in the 1920s, 1960s, and 1980s resulted in economic growth, higher employment, and increased revenues, while tax increases enacted in the 1930s and 1970s resulted in subpar economic performance.

Kuttner noted that, given stated intentions to preserve Medicare and Social Security, the tax cut would increase the deficit. Eisner cited Joint Economic Committee estimates that the tax plan would, by the year 2002, increase the deficit by $130 billion per year. He also voiced concern that the economy would be damaged by the degree to which essential programs (such as health, education, research, and welfare-to-work programs) would likely be cut in order to prevent the deficit from skyrocketing in the face of the tax cut. He also asserted that current rates of output and productivity growth are sufficient to sustain the current level of benefits paid to Social Security and Medicare recipients without raising payroll taxes (assuming the Dole tax cut is not implemented).

Eisner stated that balancing the budget, as the budget is currently measured, should not have a high priority and is potentially dangerous to the poor and middle classes because of the size of spending cuts necessary to achieve balance. When asked whether by spending cuts Eisner meant that spending growth would be restrained, he responded that in a growing economy cutting spending growth means that there is less support for programs for each dollar earned.

Changes in the Tax Burden

Bartlett cited government statistics that federal tax revenues as a share of GDP are at their highest level ever (20.8 percent) to support his opinion that the Dole tax cut is not only essential, but, in fact, too moderate. He conceded that the tax burden is lighter in the United States than in most other OECD countries, but noted that the distribution of taxes is different. In almost all of the OECD countries the rates on capital gains and income are lower and the rates on consumption are higher than in the United States. He felt that the current level of capital gains taxes is not adversely affecting the stock market, but is having a detrimental effect on the economy in terms of slower rates of new business formation and venture capital flow. Moreover, despite the fact that job creation has risen, real average weekly wages have been stagnant and at times have fallen under the Clinton administration.

Alternative Policies

Papadimitriou asked whether, if economic growth is the intended outcome, it would not be better for the Federal Reserve to reduce interest rates, thereby increasing employment and lowering the servicing costs of the national debt. Mitchell asserted that today's anemic growth has been caused by an oppressive tax system, an intrusive regulatory system, and excessive federal spending, not by monetary policy. The only job of the Fed should be "price stability, zero inflation."

Eisner stated that the debate is not about whether there should be a tax cut, but about what type and size of cut should be implemented. Tax cuts should be targeted toward human capital investment, through better education or training. Such training makes people more productive and business more likely to invest. He agreed with Papadimitriou that monetary policy should be eased.

Rubenstein advocated lowering taxes on the rich, thereby giving them an incentive to invest in productive capital that would increase the productivity of the average worker and sustain an economic recovery.

Kuttner advocated providing tax relief to working families. The Dole plan would increase the deficit, which would lead the Fed to increase interest rates, which, in turn, would slow the economy.

Program Scholars

While at the Levy Institute, Visiting Scholar **David A. Aschauer** is pursuing research interests in two areas of fiscal policy. The first line of research builds on his long-term investigation of the effect of federal expenditures (especially infrastructure investment) on economic growth and development. Aschauer is developing a new methodology for research in this area to provide further empirical evidence linking public capital and the performance of the national, state, and local economies. In his second line of research Aschauer is examining the desirability of a productivity budget for the federal government. He examines reasons for the use of public sector debt rather than current taxation for the financing of public expenditures that raise long-term productivity growth. Aschauer is Elmer W. Campbell Professor of Economics at Bates College. He received a B.A. from the University of Kansas and a Ph.D. from the University of Rochester.

Resident Scholar **Neil H. Buchanan** is concerned with issues related to public finance and fiscal policy, focusing on budgeting procedure, public investment, and the budget deficit. The first of his two current research projects is an examination of the macroeconomic consequences of current proposals to revamp or replace the federal income tax system, including an explicit analysis of the effect of such tax changes on the national saving rate. The second is a longer-term effort to continue development of the Levy Institute/New Cambridge model (Levy/NCM) of the U.S. economy, a model created and developed by Distinguished Scholar Wynne Godley. By integrating the domestic and international accounts, the Levy/NCM allows users to create simulations that capture an array of the domestic and international interactions caused by changes in the U.S. economy. Buchanan received a Ph.D. in economics from Harvard University.

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 Municiple 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*.

New Working Paper

Money, Finance, and National Income Determination: An Integrated Approach

Wynne Godley
Working Paper No. 167, June 1996

Traditional economic models have largely failed to account adequately for the roles of money and finance in economic operations. For example, traditional models assume an exogenously determined, fixed money stock and ignore the outcomes of spending changes that result from changes in bank loans. As such, traditional models take place outside of historical time and have no role for institutions in determining economic outcomes other than to promote optimizing behavior. In this working paper, Distinguished Scholar Wynne Godley presents a formalized stock-flow model consistent with the ideas of Keynes, Kaldor, and especially Hicks. Godley's model takes place in historical time and under conditions of uncertainty and incorporates a role for the financial sector in providing funding for both capital investment and firm operations, should expectations prove false. The model was subjected to numerical simulation and found solvable and stable.

Godley used Table 11.1 of the National Income Blue Book as a starting point for his stock-flow matrix. The model is of a closed economy consisting of firm, household, banking, and government sectors. The setting of the model in historical time and the prominent role of finance are apparent in the matrix's specification, most noticeably in the addition of the banking sector to the model. For example, investment, which originates in the firm sector, is funded by any combination of undistributed profits, securities issues, and the change in bank loans net of cash stocks.(1) Profit is an endogenous variable, with gross profit defined as "the flow which can potentially be appropriated by the owners of firms *and their creditors* (subject to a liquidity constraint) while leaving the firm intact" and derived as sales less indirect taxes and the wage bill, plus any change in inventories. Net profit, then, is defined as the flow "potentially extractable by the entrepreneur" and is derived as gross profits less the cost of holding goods after they are produced and before they are sold (defined as the loan rate of interest times the value of inventories at the beginning of the period). Net profit may be either distributed or undistributed, with the latter, as mentioned above, a source of funds for fixed investment. Firms set prices with the expectation of making profits, with the distribution of national income determined by the difference between the value of realized sales and costs.

Similarly, banks, which are assumed to respond passively to needs of businesses and households, derive profit by setting loan and money rates of interest in response to quantity signals. Accordingly, loans in Godley's model are factors of production. Bank liabilities, then, are a function of the demands for cash and credit, demands that are, in turn, determined by household income, spending, and asset allocations and the demand for the output of firms. (All types of demand can change based on falsified or shifting expectations.) Banks are able to fulfill their functions of always accepting deposits and making loans while still remaining profitable because of the assumption that banks will raise money rates of interest should their holdings of bills threaten to become negative. Such an action would result in households' shifting their asset holdings away from government securities in favor of M3 money. Banks are guaranteed to survive without having to borrow from government because they set the loan rate of interest independently of money rates; loan rates are therefore set at whatever rate is necessary to generate positive profits.

Note

1. "Buffer" finance provides additional funding to firms in the case of fluctuating inventories, that is, when expectations about future sales are incorrect. Expectations of both firms and households are formed adaptively, subject to random shocks.

Program Scholars

Research Associate **Steven M. Fazzari**'s current project (which also falls into the area of the federal budget policy program) is an empirical estimation of the relative importance of the channels through which fiscal policy affects investment. Fiscal policy may affect investment through its influences on (1) interest rates and the cost of capital, (2) the business cycle, and (3) firms' financial condition. Policies aimed at affecting interest ratessuch as tax incentives, budget deficits, and saving incentivesare thought to influence investment by reducing the cost of capital. Policies aimed at influencing the business cycle are believed to have a short-term effect on the health of the economy and possibly a longer-term influence through investment effects. Finally, policies aimed at altering firms' financial conditioneither through internal cash flow or through external debtcould affect the cash that firms use to finance investment internally or the health of the financial sector that provides investment finance through debt or equity issues. Fazzari's work will help direct policymakers' attention to those policies that seem to be most efficient at stimulating investment and, hence, economic growth. Fazzari is an associate professor of economics at Washington University in St. Louis. He received a Ph.D. in economics from Stanford University.

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.

Seminar

Cultural Captivity: Japan's Financial Dinosaurs Resist Change

Eugene R. Dattel, Lecturer, Former Investment Banker, and Author of *The Sun That Never Rose*

Until 1995 the U.S. media portrayed the Japanese financial sector as robust and growing and often as a scapegoat for problems within the U.S. economy. The United States was described in the media as dependent on Japanese financial institutions (JFIs) due to the large amount of government debt (over $250 billion in U.S. government bonds) held by JFIs. The success of Japan's technology and manufacturing sectors and its anticipated "conquest" of the world's financial sector were attributed to Japanese cultural traits. According to this view, crises experienced in the Japanese financial sector are mere "bubbles," a series of separate and unrelated events, and not symptoms of systemic afflictions. Eugene R. Dattel disputed the media's representation of Japan's financial sector as free of such afflictions, presenting the case that the sector is far from invincible and suffers not from momentary problems, such as the large losses incurred by JFIs (which could be absorbed by the Japanese economy), but from flaws in the structure of the JFIs. Moreover, Japanese cultural traits, rather than leading to conquest, may well exacerbate problems within the financial sector due to these structural flaws.

Dattel's contentions run counter to the common American perception that Japan's financial sector is invincible. He cited several reasons for the pervasiveness of the common misperception. The media have created images of invincibility based on little or no hard evidence. Their portrayal of JFIs as structurally superior stems from an analogy to the supposed superiority of Japanese technology and manufacturing firms. However, unlike technology and manufacturing firms--firms that must compete internationally--JFIs are not competitive, and the problems associated with such noncompetitiveness are only made worse by the presence of the *keiretsu,* groups of interwoven and cooperative Japanese firms.

The media have interpreted recent crises in the Japanese financial sector as aberrations, with their resulting claim that JFIs will emerge triumphant from these crises. Dattel asserted that a triumph is unlikely because the crises are the result of continuing structural flaws.

JFIs' powers are often interpreted as being derived from their size, superior management, and government regulation. Dattel noted that the size of JFIs is the result of the size of the Japanese economy and limits on the number and types of firms allowed to operate. Moreover, economies of scale, a major advantage of centrally organized and large institutions, do not exist in the operation of firms in the financial market.

The systemic structural problems of JFIs cited by Dattel include the rotation system, provincialism, centralization of authority, and a large bureaucracy. In the Japanese rotation system, individuals change jobs within an institution every three years. The system cultivates generalized talents, but prevents the development of the specialized technical and managerial skills necessary for the smooth and efficient operation of a complex organization. The short duration in any one position also eliminates individuals' need to succeed or even perform well, since their responsibility for past mistakes dissolves once they leave one position for another.

It has been common for the Japanese manufacturing and technology sectors to look to foreign countries to acquire needed expertise, through purchase or imitation. However, the provincialism of the Japanese financial sector has prevented it from obtaining such expertise. The JFIs' provincial nature makes them reluctant to go outside their culture and encourages their belief that there is no system suitable for them to emulate. The U.S. system is thought to be too rational and uncaring, leaving few alternatives as models for changes in JFI structure.

The centralization of authority in JFIs might be expected to lead to a highly coordinated system. However, JFIs (and the Ministry of Finance, which oversees JFIs) lack adequate risk-monitoring activities and set up departments according to administrative centers rather than profit centers.

Finally, JFIs and the Ministry of Finance suffer from the outgrowths of a highly bureaucratized structure. The lack of accountability removes checks from the system. An absence of critical thinking and a lack of objectivity result in the inability to analyze credit risk. Because the Japanese media portray bureaucrats as talented and public-spirited, no one in Japan questions the actions of the Ministry of Finance, which Dattel contended uses regulation to manipulate the market.

Dattel noted that some of the cultural factors pointed to by the media as reasons for Japanese success in other areas are the very factors that exacerbate problems in the structure of JFIs. Such factors include an isolated culture, an educational process that concentrates on rote memorization rather than analytical or critical thinking, and an avoidance of confrontation. The Japanese culture is such that the public does not challenge the existing structure.

Dattel was asked how the manufacturing sector managed to bypass the cultural roadblocks he spoke about and become successful in international markets, while JFIs appeared to be crippled by them. Dattel responded that all parts of the Japanese system are not alike. In manufacturing, for example, an outside focus provides feedback and forces Japanese firms to adapt. In contrast, the Japanese financial sector is isolated and receives no such feedback. According to Dattel, JFIs are inflexible, old-style institutions that have "squandered Japan's economic growth."

Program Scholars

Distinguished Scholar **Wynne Godley**, assisted by Resident Scholar **Gennaro Zezza**, is refining an accounting-based system of information relating to world production, trade, and investment, with special attention to their interrelationship within the U.S. economy. Godley aims to use this world model (which incorporates his previously constructed accounting-based model of the U.S. economy) to identify significant trends and magnitudes in order to reveal strategic problems and to suggest possible policy responses. With co-author George W. McCarthy Jr. of Bard College, Godley recently completed an economics textbook, tentatively titled *An Introduction to Institutional Economics*, based on his model. He is the author of *Public Policy Brief* No. 23, *A Critical Imbalance in U.S. Trade*. Godley is a professor of applied economics at Cambridge University. He received a Ph.D. in applied economics from Oxford University.

Cambridge University Visiting Scholar **Andrew J. Paulson** is examining the social and economic contexts within which the European Union is progressing toward monetary union. In particular, Paulson compares the introduction of the Euro with the unification of currency in the United States at the turn of the century. In order to develop an analogy to inform Europe's policymakers, he will examine the effects of asymmetric shocks on individual regions in the wake of monetary unification.

Cambridge University Visiting Scholar **Susannah Rodgers** will examine attitudes about privatization in Russia and other countries of the former Soviet Union. She will trace the evolution of opinions about the different forms of privatization introduced in the former Soviet Union while focusing on three themes: the historical experience of centrally planned economies, the particular structure of privatization that is adopted, and the perceived success or failure of such privatization. Rodgers's study hopes to shed light on the questions of why many Western firms remain so cautious in their investment in privatization (preferring instead to invest in joint ventures) and whether the citizens of these newly autonomous states are equally cautious in their perception of market reforms.

New Working Paper

Rethinking Health Care Policy: The Case for Retargeting Tax Subsidies

Walter M. Cadette
Working Paper No. 171, July 1996

Although President Clinton's health care plan was defeated in Congress, the problems precipitating the plan's introduction still exist or have worsened: medical costs continue to grow faster than the overall economy, more individuals are not covered by insurance, and fiscal austerity threatens coverage by Medicare and Medicaid. The nature of managed care, which tends to ration care according to price, raises concerns about quality of care and access to coverage. The near elimination of cross subsidies means the poor and those with a history of illness are far less likely to receive or retain health coverage. Hospitals are feeling increasing financial stress as a result of excess capacity, the inability to shift costs to private payers, and the decline in revenues brought on by managed care. The passage of legislation enabling those who are insured to remain insured should they lose or switch jobs provides access to coverage to a limited number of workers, but the legislation does not address the problem faced by over 40 million Americans (about 75 percent of whom are low-wage workers and their families) who have no access to health care for reasons of income. Moreover, plans enacted or discussed at the state level to cover the uninsured face problems of cost and quality of service as well as the question of "who pays" for such programs.

According to Senior Fellow Walter M. Cadette, solving the problem of access requires a new method of financing health care. In this working paper he argues for a change from the current method of financing health careemployment-based health insurance with tax-excluded premiums. This method has tended to increase the comprehensiveness and use of health care benefits. Moreover, this form of premium exclusion is not vertically or horizontally equitable because its tax benefits rise with the comprehensiveness of the insurance plan, the share paid by the employer, and the tax bracket and because the exclusion is less for those who are self-employed than for those who are covered by an employer-paid plan (30 percent versus 100 percent).

Cadette advocates switching to a system that would require everyone to purchase basic but comprehensive coverage with after-tax income. A sliding-scale tax credit, based on level of income, would then be granted. The plan could be paid for with the revenues resulting from eliminating the current exclusion (about $74 billion in federal revenues and $5 billion in state revenues) and the $11 billion the Medicaid program pays to hospitals to assist them in paying for services rendered to those who could not pay for them. Of course, decisions would have to be made as to what services would be included in "basic, comprehensive coverage," the income levels at which individuals would receive tax credits, and the size of the credits. The role of the federal government would be to ensure that all plans meet minimum standards of coverage and, possibly, to subsidize part of the cost of high-risk subscribers. State and local governments would channel funds for the insurance of nontaxpayers directly to their insurance carriers.

This method of financing health care would eliminate the vertical and horizontal inequities of the existing system and, according to Cadette, encourage individuals to seek out less expensive insurance. Furthermore, since the health insurance market would move toward catastrophic coverage, fewer claims would be processed, thereby reducing administrative costs. Subsidies currently paid to hospitals but paid for by society at large would be made transparent. Insuring those who are currently uninsured also would result in a better balance between emergency and routine care. Large firms would no longer have the advantage of being able to leverage labor costs via the exclusion, thus improving the efficiency of the labor market. The sliding-scale tax credit method also is administratively less costly than some proposals (for example, a pay-or-play plan) and easier to implement than others (for example, the universal plan in Canada). Medicaid and Medicare systems could be included in the system as well, thereby eliminating the disincentive to work now faced by Medicaid recipients.

Workshop

The Future of the Welfare State

A four-session workshop on the welfare state was held at Blithewood. In addition to Levy Institute scholars and staff, participants in the workshop included **Lawrence Mead**, professor of political science at New York University; **Howard Rosen**, executive director of the Competitiveness Policy Institute; **Howard Karger**, Graduate School of

Social Work at the University of Houston; **David Stoesz**, Samuel S. Wurtzel Professor of Social Work at Virginia Commonwealth University; and **Michael Sherraden,** George Brown School of Social Work, Washington University in St. Louis. The sessions were structured to explore the principles underlying a welfare state, provide an overview of the current welfare state, consider alternatives to the existing system, and suggest policies for improving the system.

Session I. Principles of a Modern Welfare State

Resident Scholar Oren M. Levin-Waldman asserted that deficiencies in the current welfare system (for example, its expense and problems of moral hazard) make considering its reform or replacement necessary. He assumes that some form of welfare state will exist in the future, but in a different form. For Levin-Waldman, such a state should be work oriented, assist recipients to attain self-sufficiency, and make government, at some level, responsible for helping its citizens.

According to Lawrence Mead, the key operational values of the welfare state should include freedom (both positive and negative) and equality (economic, primarily in terms of the division of inequalities associated with the distribution of income from other aspects of life). The long-term goals of a welfare state are income maintenance and/or a redistribution of income (to maintain a floor level of income and essential services), equality (compensation for private sector failures and to make society more egalitarian), and citizenship (participation in society). In structuring a welfare state, however, policymakers must also consider the tax burden that society is willing to bear for that state.

Taking what he referred to as an "ethical perspective," Howard Rosen observed that there now appears to be a feeling of resentment toward the welfare state, whereas in the past there was a sense of community responsibility for assisting the needy, with a distinction made between individuals and their problems. Rosen noted that basic principles of social justice (charity and encouraging participation in the economy, for example) stem from the Judeo-Christian tradition. He asked, Where does the responsibility for living standards lie, with the individual or with the government? What do we consider to be "public goods"? What does "public" mean as it pertains to individual goods? The answers to these questions could point to the direction a future welfare state should take. Such a state would need to encourage both personal responsibility and community action and to allow for a sense of personal freedom.

Session II. Overview of the Current Welfare State

Howard Karger noted three factors that are driving the recent welfare reform movement: the marketization of social life (injecting market principles into various aspects of social life), a redefinition of the public good as the maximization of individual welfare, and the perception that welfare programs are too large. The reform movement seeks to include elements of social control in the social contract by marketizing some public welfare programs (for example, mental health services in Texas); reestablishing the primacy of family responsibility (for example, by requiring paternity identification before welfare benefits can be disbursed) so that turning to the state becomes a second or last resort; and emphasizing elements of individual responsibility (for example, through work programs and time limits on benefits).

According to Karger, the logic of these requirements is somewhat flawed. One flaw stems from the incorrectness of the perception that welfare programs are too large. In fact, AFDC spending usually runs between $20 and $40 billion (if state and local spending is included), which is a small amount relative to spending for other entitlement programs, such as the $350 billion spent on Social Security. Another flaw lies in the assumption that placing time limits on benefits will make beneficiaries reenter the workforce. Given the lack of high-paying, upwardly mobile jobs and the current scarcity of public resources for the training, education, and work programs necessary to raise the skills of beneficiaries so that they can qualify for a job, reentry will be difficult. Because of these flaws, current welfare reforms are destined to fail. According to Karger, real reform should be based not on some idealized concept of the labor market, but on a realistic understanding that takes into account the types of available jobs and the skills required to occupy those jobs. Reform should be based on a definition of the public good that is inclusive rather than exclusive. Finally, reform should be based on real politics.

David Stoesz spoke about the development of a "voluntary sector" of the welfare state in addition to the governmental sector. This second sector consists of organizations formed to serve charitable functions (today somewhat organized in most of the larger metropolitan areas through the United Way) and to institute social change (such as the NAACP and NOW). Stoesz noted that the welfare state initiated under the New Deal focused on social insurance programs (such as Social Security) for workers and then came to include means-tested programs to provide assistance for nonworking people. Public assistance programs have been stigmatized since their inception, while social insurance programs have been regarded as positive.

A third sector of the welfare statethe corporate health and human service sectorhad its inception in 1965 as a result of a congressional decision to reimburse the private sector for health services; 1965 was the year Medicare and Medicaid were introduced. The development of this sector resulted in the marketization and rationing of health and human services, which generated the idea of a standard of necessary conduct or behavior in exchange for receiving public assistance benefits. The imposition of standards has led to the study of welfare behavior, or how people react to the standards. A couple of general findings relative to the establishment of jobs programs cited by Stoesz were (1) the increase in earnings for mothers participating in jobs programs is modest and likely to be insufficient to make them independent of public assistance and (2) savings to welfare departments through such programs are modest as the cost of reintegrating all mothers of children on AFDC into the labor market will be substantial.

Stoesz found it ironic that the most dynamic aspect of the American welfare statethe development of health and human service corporationsis being ignored in the debate over reforms. Instead of focusing solely on the very small AFDC program, policymakers should be considering how to rearrange, restructure, and reformulate the components, incentives, and workings of the voluntary, government, and corporate sectors. He would eject the current system and replace it with individual development accounts, financial maintenance organizations (community-based organizations aimed at preventing poverty, analogous to health maintenance organizations aimed at preventing illness), a welfare bureaucracy slimmed down by consolidation of service components, and special investment pools for human capital development paid for with gaming and lottery revenues.

Session III. Alternative Systems

Mead discussed citizenship (or obligations), the third of his three long-term goals of the welfare state, stating that addressing that goal was necessary before equality could be discussed. He noted that for some of the long-term poor, attaining the goal of citizenship is related to problems of competence and coping. According to Mead, social policy must deal with these problems. He commented on the trend of paternalism in antipoverty programs, that is, policies of authority that combine a measure of direction, structure, and supervision for those receiving benefits (most notably in requiring work and other obligations of adult recipients). Such programs are driven by the inadequacy of (and public opposition to) alternatives that would either give benefits without requirements or totally deny benefits. Policies that move the welfare system from a benefit system to a system that includes some authority measures appear to be more successful in dealing with "the welfare problem" than the alternatives. However, in the child development system (which could be considered a type of welfare system), the direction of change seems to be reversed; the presently unsuccessful authority system is moving toward assisting fathers to meet their obligations. One means of assistance would be to provide them with a combination of job training, government jobs, and other programs. Another, based on a military model, would establish a structure similar to the national guard that would supply the authority the remiss fathers appear to need while supplying them with the opportunity to function in ways that society values. (Other ideas about combining benefits with direction, structure, and supervision apply to programs involving criminal parole and probation, drug addiction, homeless shelters, and education.) The switch to an authority structure, however, requires a shift in thinking from an economic orientation based on money, budgets, incentives, and resources to an institutional orientation in which the central feature is the empowerment of the program staff to help people as well as to set standards.

Mead felt that the shift in structure would require not an increase in spending, but a change in how funds are spent. Such a shift would also involve changes in organization. Although the public is not in favor of bureaucracy, reforming the welfare system is a problem that appears to require a bureaucratic solution that will take time, patience, and commitment to implement. Reforms will involve all levels of government, with norms set by federal or state legislatures and programs implemented by a combination of state and local government agencies and not-for-profit and possibly for-profit entities.

Michael Sherraden stated that practices such as time limits and job obligations will become standard in welfare reform. He opined that the United States should move toward a system of individual development accounts that will, for the most part, take the place of social insurance and means-tested transfer payments. Sherraden noted that if tax expenditures are included, spending on welfare programs (including Social Security) accounts for about half the federal budget. Social insurance programs account for roughly one-half of welfare spending ($600 billion); means-tested transfers (including Medicaid) account for about one-sixth of the total (about $200 billion); and one-third is in the form of tax expenditures (such as deductions for home ownership, 401Ks, and IRAs). Sherraden argued that tax expenditures are the most effective part of the American welfare state in terms of building capacity because these institutional mechanisms generate asset accumulation. Such accumulation incentives, however, affect only the middle and upper classes and not the poor, who have disincentives to save or accumulate assets. Accumulation is important for social reasons as well as economic: In the United States owning something makes people more active in civic affairs and makes them think about the future.

Sherraden noted that his background as a social worker led him to realize that benefit recipients can be caught in a cycle of poverty because they lack access to funds (or the incentive to accumulate funds) that would allow them to plan for the long term. His concept of individual accountssavings matched by government or someone in the private sectorwould provide incentives for the poor to save. He cited as an example Singapore's asset-based policy, which started out as a state-sponsored, mandatory savings system for retirement, was later expanded to include savings for home ownership, education, and health care, and has resulted in significant capital accumulation. A bonus is that because the same instrument is used for multiple purposes, the policy reduces the need for separate, competing bureaucracies. According to Sherraden, such a system is more democratic that the current system of categorical programs, which predefine people's needs and then ask whether people qualify for them. Sherraden predicted that by the middle of the next century individual accounts will dominate social insurance as a principle of public policy. In order to deal with the changing economic structure, social welfare policies must be flexible and mobile across national borders, such as portable accounts.

Session IV. Rethinking Policy (Roundtable Discussion)

Executive Director Dimitri B. Papdimitriou charged the participants with listing policies they felt would assist in "fixing" the welfare system. He started the discussion by listing some policies implemented in other countries: policies focused on children and poverty and the Canadian system of transfers. Papadimitriou noted that simulation results have shown that implementing a Canadian-style system in the United States would significantly reduce poverty. Unfortunately, such programs are expensive.

Among the suggestions by Stoesz were

- Standardized unemployment compensation with benefits calculated regionally

- Setting the minimum wage at 50 percent of the regional median wage

- Coupling the minimum benefits package to the minimum wage and incorporating child day care in the minimum benefits package

- Universalizing individual development accounts

- Incorporating a rolling amnesty date in immigration policy

- Assuring health care to all American children

- Universalizing prenatal care by expanding the WIC and Healthy Start programs

- Eliminating the poverty index by tying benefits (at about a 40 percent rate) to regional wages

- Establishing community development banks to generate financial resources in poor areas

- Providing full mental health, health, and juvenile services in the children's services authorities to replace current social services

- Making community services authority available through vouchers

- Creating human capital development funds by taxing gaming and lottery revenues

- Reassigning child and adult protective services to the police to criminalize child abuse

- Restoring the deduction for charitable contributions to nonitemizers

- Establishing volunteer tax credits for those volunteering more than 30 hours per month to nonprofit organizations

- Instituting penalties for health and human service providers who discriminate against clients who are publicly sponsored

- Mandating community services as a requirement for professional licensing

Papadimitriou asked whether implementing this list of programs would be revenue neutral. Stoesz responded that most of the proposals would be revenue neutral and the others would not require a large increase in spending. He claimed programs have not been implemented for political, rather than budgetary, reasons: Liberals, wary of conservatives who would make programs more punitive, are defending the welfare state at all possible costs, resulting in a stalemate.

Suggestions from other participants included instituting a national health care system, raising the minimum wage somewhat, and implementing administrative reforms to the EITC program. All agreed that any welfare reform will require federal leadership.

Debates-Debates

The Economics of Aging

It is frequently stated that the Social Security retirement system will be in bankruptcy by 2030 and that fiscal restraint implies that retaining current entitlements to the elderly can be done only at the cost of reduced spending for other programs, such as education and health care for other members of society. The topic of a recent segment of the PBS television program *Debates-Debates* was the question raised by S Jay Levy last year in Levy Institute *Public Policy Brief* No. 18, *The Economics of Aging,* "Can We Afford Grandma and Grandpa?" Panelists offered remedies that ranged from privatizing the Social Security system to limiting protection to the frail and poor among the elderly.

The panelists who argued that the Social Security retirement system is still viable were **Jerry I. Mashaw,** Sterling Professor of Law at Yale Law School; **Robert Butler,** director of the International Longevity Center and professor of geriatrics at Mount Sinai Medical Center; and **Lydia Bronte,** director of the Project on Postponing the Illness of Aging and author of *The Longevity Factor.* On the opposing side were **John C. Goodman**, president of the National Center for Policy Analysis; **S Jay Levy**, chairman of the Levy Institute; and **Peter G. Peterson**, chairman of the Blackstone Group and president of the Concord Coalition.

Those arguing that the system is not viable made the following assertions.

- Government bonds issued as promissory notes for the funds that workers pay in Social Security taxes are empty promises that lay impossible burdens on future generations (Goodman).

- Funds now paid into the Social Security system should be invested in projects that could increase the fund for future retirees and promote growth in the U.S. economy (Goodman).

- It is unlikely that by 2030, when the ratio of workers to retirees will have declined to two to one, workers will be willing to support the pool of unproductive (retired) people given the cost to the workers' children (Levy).

- It is questionable whether a society can function when most of its resources flow into the pockets of an unproductive cohort, especially given that the current U.S. rates of saving and investment are the lowest among industrial countries (Levy and Peterson).

Peterson advocated a system such as in Chile, where deductions from workers' paychecks for retirement are allowed to be privately invested. He asserted that this system was responsible for the increase in the Chilean saving rate to 27 percent of GDP (as compared to a rate of about 5 percent in the United States).

Those arguing that the system was still viable made the following claims.

- With marginal changes, the Social Security system could protect older workers while avoiding means testing or privatization (Mashaw).

- Age bias is pervasive in our society and individuals who want to work are being forced into involuntary retirement in large numbers (Bronte).

- Productivity could be improved by making better use of the talents and skills of the 40 million currently retired persons (Butler).

- It is questionable whether investing retirement funds in equity markets, given the risk, is advisable (Butler).

Mashaw agreed that we should be doing a better job in managing the Social Security fund to make the money deducted for future retirement grow. He advocated raising the retirement age to conform to the longer, healthier lives of workers as one means to ensure the fund's solvency. Bronte recommended tax breaks for corporations that retain older workers and the expansion of part-time job opportunities for older workers. Noting the aging of the population, she criticized as inefficient policies that discourage the participation of older people in the workforce and asserted that involuntary retirement represents a large social loss. Butler suggested raising to above $62,700 the maximum income on which an individual pays Social Security taxes.

Program Scholars

Senior Fellow **Walter M. Cadette**'s areas of special interest include public policy, business capital spending, and international trade. Cadette is examining the options available in the aftermath of the failure of the Clinton administration's health care plan. This examination will include (1) a description of the health care delivery system in the United States, including Medicare and Medicaid, the private third-party payment system, sources of escalating health care costs, and the rising number of uninsured; (2) an analysis of responses of the government and the private sector to rising health care costs; and (3) an analysis of the policy choices available to remedy existing problems. Cadette is a former vice president and senior economist at Morgan Guaranty Trust Company and editor of the bank's publication *World Financial Markets*. He received an M.A. from Georgetown University and did further graduate work in economics and finance at New York University.

Research being conducted by Research Associates **Kris Feder** and **Michael Hudson** will assess 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, assistant professor of economics at Bard College, previously taught at Franklin and Marshall College, West Chester University of Pennsylvania, and Temple University. Her areas of specialization are public sector economics and history of economic thought. Feder received her Ph.D. in economics from Temple University. Michael Hudson is a visiting scholar at New York University. He has served as consultant to institutional investors on balance of payments and flow of funds analysis and as economic adviser to government agencies and the United Nations Institute for Training and Research. He was research director for the Henry George School of Economics and Sociology. He received his Ph.D. in economics from New York University. Feder and Hudson are co-authors, with G. J. Miller, of *A Philosophy for a Fair Society*, published by Shepheard-Walwyn.

Cambridge University Visiting Scholar **David Seddon** is examining the effects of institutional shareholder activism on long-term corporate performance and behavior. He will focus on the role that the current corporate governance system has played in the shift toward maximizing shareholder value as the overriding goal of public corporations and on the consequences of this shift.

Institute News

Alan S. Blinder Rejoins Board of Advisors

The Board of Governors of The Jerome Levy Economics Institute is pleased to announce the appointment of Alan S. Blinder to the Board of Advisors. He is returning to the board after serving as a member of President Clinton's Council of Economic Advisers and, most recently, as vice chairman of the Board of Governors of the Federal Reserve. Blinder is Gordon M. Rentschler Memorial Professor of Economics at Princeton University. He received a B.A. from Princeton University and a Ph.D. from the Massachusetts Institute of Technology.