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The Jerome Levy Economics Institute of Bard College

# Summary

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## **Letter from the Executive Director**

To our readers:

This issue of the *Summary* includes activities in three research programs and miscellaneous research topics. In the employment policy and labor market structure program are five new working papers and a seminar. Resident Scholar Oren M. Levin-Waldman examines congressional voting patterns and finds that the politics of the minimum wage are of great importance and economic models are of less importance in determining members' votes on minimum wage issues. Research Associates William J. Baumol and Edward N. Wolff, both of New York University, argue that rapid technological progress has the effect of elongating the duration of unemployment and that three classes of workers - the poorly educated; older, former jobholders; and women - are most adversely affected. Research Associate Robert Haveman, of the University of Wisconsin at Madison, Lawrence Buron, and Andrew Bershadker present a new statistic, the capacity utilization rate, as a measure of degree of underemployment. Senior Scholar Joel Perlmann is the author of two papers. In the first he focuses on the extent to which Jews concentrated in (or moved into) manufacturing (especially skilled artisan trades) versus petty trade occupations. In the second he refutes scholars who have dismissed literacy data from the 1897 Census of the Russian Empire as useless and offers a new interpretation to account for the data. In the seminar, Katharine Newman, of the Kennedy School of Government at Harvard University, presented the results

of her study on inner city labor markets, in which she dispelled some of the common mistaken beliefs about the working poor and their ability to find work in the inner city.

The federal budget policy program includes a summary of two new working papers. Resident Scholar Neil H. Buchanan analyzes the macroeconomic effects of current proposals to reform the tax system to see the extent to which they promote saving. Resident Scholar Oren M. Levin-Waldman examines some of the possible effects of the new welfare law and offers a policy prescription to achieve a more comprehensive, coherent, and efficient employment program through combining welfare, job training, and unemployment programs.

The program on restructuring in the financial services sector includes summaries of seven papers on the work of Hyman P. Minsky presented at the national meeting of the Allied Social Sciences Association in New Orleans.

One working paper is summarized under miscellaneous research topics. Robert S. Chirinko, of Emory University, Research Associate Steven M. Fazzari, of Washington University in St. Louis, and Andrew P. Meyer, of the Federal Reserve Bank of St. Louis, estimate the user cost elasticity of capital. Their range of point estimates is far different from the unitary value assumed in studies employing Cobb Douglas production functions, leading them to conclude that the effects of the traditional monetary transmission mechanism and of tax policies aimed at stimulating capital formation will likely be weaker than previously thought.

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

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## New Working Papers

### **Exploring the Politics of the Minimum Wage**

**Oren M. Levin-Waldman**  
**Working Paper No. 176, November 1996**

Resident Scholar Oren M. Levin-Waldman argues that although the minimum wage is a serious economic issue, enacting an increase in the minimum wage is a political one. He finds that because the empirical results of an increase in the wage floor are "inconclusive," legislating an increase is ripe for political manipulation. He looks at congressional voting patterns and finds that the politics of the minimum wage are of greater importance in regions with right-to-work laws and that members of Congress will base their vote on the issue according to constituent interests, even if those interests run contrary to party ideals. In the absence of strong constituent feelings, the results of economic models may play a part in determining a member's vote.

Levin-Waldman cites findings that both support and refute negative employment effects of a rise in the minimum wage. On one hand are studies that indicate that by setting a binding wage floor, increasing the minimum wage reduces employment in the youth labor market. On the other hand are results that indicate that raising the minimum has no adverse employment effects. He notes that although there has been controversy about the findings, the "principal concerns have been with the unknown," for example, the effects of a large wage increase on employment. Because there are no "conclusive data" on which to base definitive statements about the effects of a change in the minimum wage, conclusions about such changes are based

on the model employed, the legitimacy of that model, and the fact that different groups have different stakes in supporting each. Levin-Waldman concludes that a political model is likely to tell us more about the minimum wage than traditional economic analysis.

Levin-Waldman notes that one political issue associated with the minimum wage literature is why research has focused on the effects on the youth labor market. One possible explanation is publication bias in favor of studies with statistically significant results or of models that show that increases in the minimum wage lead to decreases in employment. Another issue stems from linking increases in the minimum to policies to reduce poverty. Because poverty programs have in recent years been under political attack, the argument that a reason for raising the minimum wage is that it will reduce poverty has been ineffective. Moreover, such a link moves the debate on minimum wage issues out of the more "positive" realm of the labor market and into a realm associated with social stigma (poverty), thereby reducing the political imperative for action.

Levin-Waldman also notes that a rise in the minimum wage is likely to have different consequences in different regions of the country. There likely will be less pressure (in the form of lobbying efforts) to increase the minimum wage in regions with high relative wages and with strong right-to-work laws. He examines congressional voting records on minimum wage legislation in 1955, 1977, and 1989. Although Democrats generally tended to vote for increases and Republicans against them, Levin-Waldman finds exceptions to the trend to be of special interest. For example, members of Congress, particularly Republicans, from states with high union densities relative to densities in right-to-work states voted in favor of the increases. This is interesting given the fact that union membership in these states was low relative to the overall workforce.

## **Protracted Frictional Unemployment as a Heavy Cost of Technical Progress**

**William J. Baumol and Edward N. Wolff**  
**Working Paper No. 179, December 1996**

In this working paper, Research Associates William J. Baumol and Edward N. Wolff, both of New York University, explore the effects of the rate of technological progress on unemployment. They hypothesize that the sunk costs associated with a worker's training will depend on his or her previous training and education and the current pace of technological change. The faster the pace of change, the greater the sunk training costs, although education moderates the magnitude of those costs. A firm weighs wage and sunk training costs against a worker's marginal revenue yield. These factors combine to the disadvantage of the poorly educated, who will be forced to accept either a low wage or a longer duration of unemployment. A faster pace of technological change will exacerbate this disadvantage.

In their empirical investigation Baumol and Wolff examine the trends of five technological variables, four institutional variables, and labor force participation rates by age group and gender. They find that the duration of unemployment remained fairly constant in the 1950s, 1960s, and 1970s and rose in the 1980s and 1990s. The only technological variable found to be closely and positively correlated to the duration of unemployment was investment in office, computing, and accounting equipment per full-time equivalent employee (FTEE). Total factor productivity (TFP) growth was negatively correlated with the duration of unemployment. The unemployment insurance (UI) coverage rate and the UI replacement rate were found to have been rising gradually over the entire postwar period, although neither showed the degree of increase exhibited by the duration of unemployment. The duration of unemployment increased for older workers and declined for younger workers from the 1980s to the 1990s.

The results of regression analyses of aggregate data and sectoral data indicate that the only variables having a significant effect on the duration of unemployment in all or nearly all of the specifications were the UI replacement rate and TFP growth (unadjusted and adjusted for cyclical variation). Using aggregate data but specifying the mean duration of unemployment by individual age groups as the dependent variable, Baumol and Wolff find that a 1 percentage point increase in TFP growth is associated with about a 4 percentage point decline in the average duration of unemployment. Average annual investment in new machinery and equipment per FTEE was significant and negatively related to the duration of unemployment in the regressions that included younger age groups, suggesting that younger workers are favored by new technology embodied in new equipment. The authors find that \$1,000 of additional investment in new machinery and equipment per FTEE reduces the duration of unemployment among young workers by about 20 percent.

From these results Baumol and Wolff conclude that the duration of unemployment increases as the pace of technological change increases and that such change affects older workers more adversely than younger workers. However, the most important influence on the increase in the duration of unemployment was not the pace of technological change, but the UI replacement rate. This last result is not because UI benefits have risen (they have remained fairly constant since 1983), but, more likely, because average weekly earnings have declined.

## **The Utilization of Human Capital in the U.S., 1975-1992: Patterns of Work and Earnings among Working-Age Males**

**Robert Haveman, Lawrence Buron, and Andrew Bershader**  
**Working Paper No. 180, December 1996**

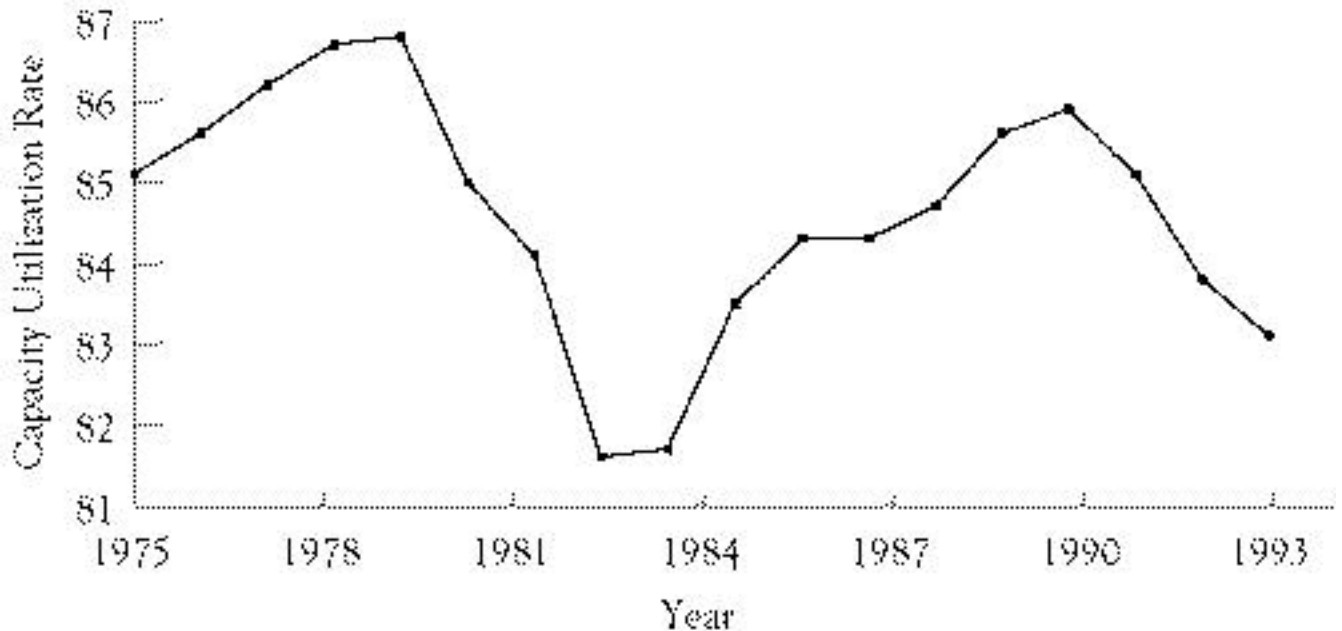
In this examination of underemployment among workers, Research Associate Robert Haveman, of the University of Wisconsin at Madison, Lawrence Buron, and Andrew Bershader present a new statistic, the capacity utilization rate (CUR), as a measure of "the extent to which the use of human capital falls short of a full utilization norm." Full capacity is defined in terms of hours worked full-time and year round (or 2,080 hours) and individual productivity at a wage rate consistent with the productivity predicted by a worker's characteristics. The potential earnings associated with full capacity are measured as an individual's predicted wage rate multiplied by 2,080 hours; a worker earning less than these potential earnings is underutilizing his or her human capital. A probit model was used to estimate predicted wage rates; because the *Current Population Survey* data the authors used included only individuals who were working, the estimated coefficients were corrected for potential selection bias. Predicted earnings also were used as a proxy for actual earnings.

Per capita CUR is then

$$\frac{\sum_{i=1}^N \text{Earnings} / N}{\sum_{i=1}^N \text{Potential earnings} / N}$$

where N is the number of workers in any given set of working males, I.

Haveman, Buron, and Bershadker find that between 1975 and 1992 per capita (real) earnings declined 11.8 percent and per capita potential earnings declined 9.6 percent. The ratio of earnings to potential earnings - the CUR - declined 2.4 percent over the period. Regressions run on the series indicate that the decline in per capita earnings is the result of declines in the level of potential earnings and in the proportion of realized potential earnings. As Exhibit 1 shows, the trend in the CUR is erratic, reflecting business cycle effects on the measure. After adjusting for these effects, the authors find that the "macro-constrained" CUR declined steadily over the period; between 1975 and 1992 the measure fell by 2.3 percent. The decline implies that the underutilization of the male human capital stock has been experiencing a secular increase during the period.



**Exhibit 1. Capacity Utilization Rate (CUR), Males Aged 18-64, 1975-1992**

Haveman, Buron, and Bershadker examine the patterns of the prevalence of underutilization of 32 age, race, and education groups, using as an indicator the percentage of working-age males employed at less than 2,080 hours.(1) Some of their findings are:

- The youngest workers (18–24 years) had the highest level of prevalence and the oldest (55–64 years) were the only ones to show a steady increase in prevalence over time.(2)
- Among education groups, high school dropouts experienced the highest level of prevalence.
- Of the eight race-education groups, only nonwhite college graduates experienced a decline in prevalence, while white high school dropouts experienced the highest rate of increase in prevalence.
- Among the race-age-education groups, young dropouts of all races registered a level of prevalence (about 73 percent) that was high but fairly constant over time. This was in contrast to dropouts in the other age groups, who experienced a rapid increase in prevalence.

As Haveman, Buron, and Bershadker note, this last finding is interesting in that "it is at odds with the general perception that the young, least educated - and nonwhite - groups have experienced the greatest labor market deterioration in recent years."

A lack of available work and illness accounted for most (77 percent) of the underutilization of

human capital. Contrary to reports in other studies, however, Haveman, Buron, and Bershadker find that illness is a decreasing contributor to forgone potential earnings. After dividing the reasons for forgone potential earnings into exogenous factors (lack of work opportunities, illness, and discouragement in seeking work) and individual responses to incentives (retirement, voluntary part-time work, and housework), they estimate that if underutilization had been caused only by individual responses, the CUR would have fallen from slightly more than 95 percent in 1975 to about 93.5 percent in 1992.

In analyzing shifts in actual and potential earnings and the gap between the two by age-race-education groups, the authors find that the gap was higher for whites than nonwhites and more of the gap for nonwhites was attributable to exogenous factors. Within age groups, the ratio of per capita potential earnings for the youngest group to that for the oldest group fell dramatically over the period, primarily the result of a substantial drop experienced by the former (\$2,700 per decade for the younger group compared to \$960 per decade for the older group). The gap between earnings and potential earnings, however, declined for the youngest group (the result of a decline in the amount attributable to exogenous factors, primarily macroeconomic performance), but rose for the oldest group (the result of a rise in the amount attributable to individual responses to incentives, primarily retirement). Within educational groups, per capita potential earnings declined for all but college graduates. For the two lowest education groups (dropouts and high school graduates), actual earnings declined at an even faster rate than potential earnings, resulting in a dramatic decline in the CUR.

In order to explore labor market patterns among the most vulnerable of the examined subgroups, the authors compare underutilization patterns among the youngest and oldest nonwhite groups with the least amount of education (dropouts and high school graduates) to those of the average male in their age group and the average working-age male. They find that human capital utilization declined for both younger and older, low-education, minority workers.

Nonwhite youths of both low-education groups experienced a nearly 16 percent decline in potential earnings (as compared to a 15 percent decline among all youths and a 5 percent decline among all males). Nonwhite youths also posted low CURs - 57 percent for dropouts and 71 percent for high school graduates - primarily the result of exogenous factors (unemployment, illness, and discouragement). However, the CUR declined for nonwhite, low-education youth; the gap between earnings and potential earnings declined and by more than that among all youth and all male workers.

Older nonwhites with low levels of education also posted declines in potential earnings and a large gap between earnings and potential earnings. There was a 9 percent decline in potential earnings for older, nonwhite dropouts and a 6 percent decline for high school graduates (as compared to a 3 percent decrease for all older workers), but these declines were far less than those experienced by nonwhite youth with similar education levels. Similarly, the CUR for older, nonwhite, low-education workers was low relative to their age cohort, ranging between 60 and 65 percent as compared to 73 percent for all older workers and 85 percent for all males. But unlike the CURs of young workers, the gap between earnings and potential earnings for older workers rose (by about 10 percentage points for dropouts and nearly 15 percentage points for high school graduates). As was the case for all older males, the primary reason for the gap for these workers was illness and the cited reason for the decline in the gap was unemployment.

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## Notes

1. The 32 groups result from combinations of four age groups (18-24, 25-39, 40-54, and 55-64), four education groups (less than 12 years, 12 years, 13-15 years, and 16 or more years), and two racial groups (whites and nonwhites).

2. The authors note that the oldest group also was the only age group in which prevalence was greater among the more educated members, which they suggest indicates "voluntary substitution of leisure for work time by individuals with high permanent income."

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

**Joel Perlmann**

**Working Paper No. 181, December 1996**

Research by Senior Scholar Joel Perlmann includes an examination of possible reasons for the greater upward economic mobility (relative to other immigrant groups) of Russian Jewish immigrants to the United States at the turn of the century. As part of this research, Perlmann focuses on the extent to which Jews concentrated in (or moved into) manufacturing (especially skilled artisan trades) versus petty trade occupations. The author does not claim that this line of inquiry will resolve all aspects of the mobility issue, but it does "go to the heart of current social science interpretations of American Jewish social mobility."

Perlmann examines the evidence in favor of a structural explanation of mobility (which stresses an economic fit between immigrant occupational skills and the U.S. economy) and a cultural explanation (which stresses, for example, a tradition of learning, psychological factors, or assigning status to particular occupations). The structural hypothesis holds that the crucial contributing factor to Jewish immigrant mobility was the concentration of these immigrants in skilled occupations within manufacturing - skills that were easily transferrable.(1) The argument is that East European Jews had been concentrated in trade and handicraft occupations before coming to the United States; skilled artisans made up a disproportionate share of Jewish immigrants (both relative to other immigrant groups and relative to the proportion of East European Jews in those occupations in their native countries); and these skills provided Jewish immigrants a "leg up" into the middle class. Perlmann examines the plausibility of two elements in this argument, namely, that those with trade and handicraft skills were more likely to emigrate and that these skills gave them an advantage in the industrialized U.S. economy.

Perlmann notes that evidence for occupational selectivity is "more problematic than has been appreciated," in part because of the different data sources used to prove such selectivity.(2) Another reason is that although artisans were characterized as being in "industrial occupations," many of them worked in small-shop settings with a high proportion of self-employed workers. Therefore, even if not self-employed themselves, they had daily, close-range observation of those who were so employed and thus had ample background in the commercial aspects of running a business. The line between skilled manufacturing and commercial occupations was, therefore, blurred, and this overlap reduces the degree of selectivity shown by some of the data sources.

In order to examine the plausibility that skilled occupations gave Jewish immigrants a "leg up," Perlmann looks at the types of occupations claimed by East European Jews upon entering the United States, using 1910 and 1920 Census data. He compares these immigrants (70 percent of whom claimed a background in skilled industrial occupations) to English and Scottish immigrants (58 percent of whom claimed such a background) and to immigrants as a whole to see if patterns of occupational concentration were similar.(3) He finds no difference between English and Scottish immigrants and all other immigrants in percentages in trade or in self-employment, while East European Jews showed a higher concentration in both trade and self-employment than the other two groups. He also finds that the shift by East European Jewish immigrants from industrial to trade occupations was not concentrated in one sector,



but occurred in a variety of sectors.

Perlmann reasons that the fact that many East European Jews had been skilled artisans working in small shops, especially in the garment industry, cannot stand alone as an explanation of the movement of these Jews into trade occupations; if so, many English and Scottish immigrants would have had similar experiences. Another possible explanation indicating that "the transferability of specific skills was more complex than has been thought" is that the background of East European Jews in trade was relevant in the same way that industrial skills were relevant. A third possible explanation is that a degree of status was associated by East European Jews with trade, an explanation in which the cultural and structural hypotheses are difficult to separate. Perlmann concludes that one or both of the second and third explanations need to be added to the first in order to make sense of the occupational patterns of East European Jews at the turn of the century.

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## Notes

1. Other structural factors, such as experience in urban versus rural settings, may have played a part as well, but background in manufacturing skills is considered the crucial factor in the structural argument.
  2. See Levy Institute Working Paper No. 172, "Selective Migration as a Basis for Upward Mobility? The Occupations of the Jewish Immigrants to the United States, ca. 1900," for an analysis of data sources and the extent to which they support the selectivity argument.
  3. Although the difference in these percentages (of Jewish immigrants claiming a background in skilled trade versus English and Scottish immigrants claiming such a background) may seem large, it is not large when compared to the percentage of the remaining immigrants that claimed a similar background in skilled industrial occupations (only 15 percent).
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## Literacy among the Jews of Russia in 1887: A Reanalysis of Census Data

**Joel Perlmann**  
**Working Paper No. 182, December 1996**

Senior Scholar Joel Perlmann argues that literacy data from the 1897 Census of the Russian Empire are valuable, refuting scholars who have dismissed them as useless. Perlmann offers a new interpretation to account for the data.

Literacy data on Russian Jews in the 1897 Russian Census have been criticized by scholars as being too low (the literacy rate among Jewish males is listed as 49.4 percent, for example). Critics argue that since nearly all Jewish males attended heder (Jewish primary school) for at least some period of time, literacy rates should be substantially higher. According to Perlmann, however, the data should not be so quickly dismissed; they may be misleading rather than incorrect. For example, the 49.4 percent rate for males is calculated from a base of all Russian Jews including infants and children, who made up a large proportion of the Russian Jewish population.<sup>(1)</sup> With adjustments for a smaller, more relevant base and to exclude Jews who lived in Poland, the literacy rate for Russian Jewish males rises to 75.0 percent.

To find out if his adjusted rate is still too low, Perlmann looks for a credible data source with which to compare the new figure. He selects the 1926 Soviet Census, which recognizes Yiddish as a national language and contains detailed data on Jewish literacy. Perlmann's comparisons of age cohorts lead him to challenge the conclusion that the 1897 Census "drastically underreported" Russian Jewish male literacy. He notes that we can surmise

something about literacy rates among younger males between 1890 and 1900 from the 1926 data on males aged 50 years and older. For example, in 1926 literacy rates among males over the age of 50 ranged from 62 percent to 85 percent (see Exhibit 2). We cannot reasonably conclude, based on this data, that literacy in 1897 was universal among Russian Jewish men.

Age Cohort		Percentage of Men Able to Read	
1897	1926	1897	1926
na	20-29	na	95
na	30-39	na	93
na	40-49	na	89
20-29	50-59	76	85
30-39	60-69	75	79
40-49	70-79	72	72
50-59	80-89	67	62
60+	na	60	na

**Exhibit 2. Literacy among Adult Jewish Males in the 1897 Russian and 1926 Soviet Censuses**

*Note* : See notes to Table 4 of the working paper for details on the included populations and the total size of the age cohorts.

*Source* : *Recensement de la Population de l'U.R.S.S. 1926* , vol. 17 (Moscow: 1929; Russian and French), 76, 93, 105.

Perlmann then offers a new interpretation of the literacy data. He suggests that although nearly all men did attend *heder* at least briefly, a substantial minority were able to read only the Jewish prayer book (*Sidur* ) and were unable to transfer this ability to any other medium.(2) He concludes that this type of literacy may account for some of the discrepancy in the literacy rates in the 1897 and 1926 Censuses, but that the exact extent of the discrepancy accounted for by it cannot be estimated because the subpopulations on which the Censuses are based are too limited in scope.

## Notes

1. Of the total Russian Jewish population, 28 percent were under the age of 10 and 24 percent between the ages of 10 and 19.

2. From their knowledge of their prayers, these men could sound out Hebrew letters and link Hebrew letters to words in the *Sidur* , but their literacy was limited to this book alone.

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## Seminar

### The Working Poor in the Inner City

**Katherine Newman, Cultural Anthropologist and Professor of Public Policy, Kennedy School of Government, Harvard University**

In her lecture, Katherine Newman dispelled some of the common mistaken beliefs about the working poor and their ability to find work in the inner city. She based her conclusions about inner city labor markets on a comparative study of New York City (focusing on central Harlem) and Oakland, California - cities that had a strong manufacturing base that is now deteriorated, were the site of military bases that were progressively shut down, had suffered from depopulation, and are surrounded by considerable wealth. She reported primarily on her findings on central Harlem.

Newman found that despite the high incidence of poverty in central Harlem (over 40 percent of households), 67 percent of households have at least one member who works full-time. About one-third of these workers have administrative or professional jobs, another one-third have clerical jobs, one-quarter are employed in the service sector, and one-tenth work in manufacturing. Newman studied workers in the service sector because jobs in this sector have become the gateway to the working world for most people, replacing the manufacturing, military, and public sector jobs that are no longer as available as they once were. An understanding of working poverty and ghetto life in the 1990s therefore depends on studying service sector workers and filling in the gaps in knowledge about job search patterns, job mobility patterns, and the racial ordering of the service sector labor market.

Newman followed employees at eight fast-food restaurants - the canonical employer of entry-level workers. Her team conducted an intake study of 400 employees. From these, a stratified random sample of 120 was selected for intensive life interviews, including workers' perceptions of the labor market and the racial ordering of the economy. Of the 120, 20 were tracked day-by-day. Each of the 20 also kept a diary from which their perceptions of daily life might be gleaned. Members of the research team spent about four months working in the fast-food industry assessing jobs' necessary skills, interviewing managers, observing promotion patterns, and studying the racial breakdown of workers. An additional study - comparing applicants for fast-food jobs who were rejected during a five-month period (a random sample of 130 from a pool of 300 people) to applicants who succeeded in obtaining a job but had been employed for less than a year - was conducted to examine possible reasons why people did not obtain employment.

Newman wished to answer four basic questions. First, given that wages are so low, the underground economy so tempting and flourishing, and public assistance so easy to obtain, why would people choose to work at all? She found that work was considered a means of escaping the dangers of the streets and reaching a place of order and structure amidst chaos. There was a strong belief in the value of work and the dignity of being a working person. There also was a compelling sense of responsibility toward the natal family. About half of the working sample took their first job before the age of 15 to handle the marginal costs of their presence in their household. Given the low wages and the fact that some workers had children of their own, workers could not create an independent household, but could contribute to the central coffer of their natal household. Finally, work was a self-funding financial aid system for those who were trying to stay in school. About half the fast-food workers in central Harlem had a high school diploma, half of the high school graduates were enrolled in some form of post-high school educational program, and most of those without a high school diploma were enrolled in some type of course work. Entry-level jobs made possible that type of investment in human capital.

The second question addressed by Newman was, How hard is it to obtain a low-wage job and how do workers go about it? Conservatives contend that there are jobs available that are easy to come by and have no skill requirement; therefore, if a person does not work, he or she must not want to work. Liberals contend that ghetto unemployment is the result of social isolation, an evaporation of social networks. Is either of these views true? Newman's study of rejected job applicants in central Harlem suggests that it is not too easy to

find a job in the inner city.

She found that rejected workers looked hard to find work. About 73 percent were still unemployed one year after they had applied for jobs at fast-food restaurants. Even the youngest among them had applied for four or five other jobs outside of fast food. Moreover, as a group they were experienced workers, having held an average of three jobs in the past. And contrary to the findings of some researchers, these workers' lack of employment was not based on expectations of high wages; Newman found that reservation wages in central Harlem were close to the minimum wage. Rather, lack of employment was the result of there being too many people for too few openings.

There were, however, several characteristics that distinguished those who were successful in obtaining employment from those who were not. Hiring owners and managers preferred

- Older workers to younger workers
- Workers of almost any race to African American workers (no whites were included in this sample)
- Outsiders (those not living in the immediate neighborhood) to locals (this was true even when holding race, immigration, and human capital constant)
- Workers who knew others already working in the restaurants to workers without such contacts
- Immigrants to natives
- Workers who reported they were not receiving any welfare benefits to those who reported they were receiving any type of aid

Owners gave as a reason for preferring outsiders that friends of employees can cause disruptions when they visit employees. However, the fact that studies of other industries have shown the same preference for hiring nonlocals gave Newman pause. She associates this preference with a phenomenon she calls "the ghetto you don't know," that is, the ghetto an employer does not see somehow looks more appealing than the ghetto in which he or she lives or works. Accordingly, employers and managers exercise preferences excluding people from the immediate neighborhood in favor of others who look the same and have the same skills but come from outside the neighborhood. Newman noted that this phenomenon has implications for policies regarding empowerment zones targeted at employment. The policies establishing these zones should specify exactly who is to be hired because, while such zones may stimulate employment, the jobs may be going to nonlocals.

Newman's third question was, What are the social and cultural consequences of getting a job, particularly for young people? Newman found that a combination of the stigma associated with low-wage, fast-food jobs and increased time demands created both problems and opportunities for working youth. Workers are teased and looked down upon by other youth from their neighborhood for wearing a uniform, having to display deference, and earning low wages. To avoid stigmatization, working youth will often commute long hours to work outside their own community.

Time demands may create a sense of order, structure, and purpose for the worker that spills over into school and other parts of life. Contrary to much of the school-to-work literature, which argues that work is not good for young people because it disengages them from schooling, Newman found that for most workers from central Harlem, many of whom are not college bound, going to work has major, positive ramifications for their school life and performance.

The twin pressures of stigmatization and time demands cause workers to pull away from nonworking friends in favor of friends from work, so that their social life is increasingly dominated by associations in the workplace. These associations reinforce their identity as a working person and their definition of themselves in terms of the mainstream working world. The tightening of social connections among workers has important consequences, especially for young women from inner cities, in which out-of-wedlock pregnancy is a large contributing factor to poverty. Women included in the study who became pregnant faced a choice between welfare and work. Newman found that those who chose to terminate their pregnancies did so in order to protect their work status. Most of those who chose single motherhood had a partner who was working.

Newman's fourth question was, Do these low-wage jobs lead anywhere, and, if not, why not? In Newman's study workers were tracked for only 18 months, which is too short a period on which to base answers to this question. Nevertheless, she chronicled the workers' attempts to find better jobs. Most of the attempts fail. The workers who find better jobs are those with no demands by others on their income or time; they can put their earnings toward education or obtaining meaningful credentials. However, most employees working at the low

end of the wage scale have to contribute financially to their household and cannot afford to drop out of the labor force to obtain training. They still attempt to find better jobs, but given the constraints on their time and income and the inability of the social networks linking the working poor to facilitate upward mobility, few are able to procure higher-paying jobs.

Newman suggested several directions that policy might take to help the inner city working poor. She advocated creating better networks to facilitate mobility for these workers, such as school-to-work networks. In Japan, for example, high school graduates obtain jobs through school-based networks. She recommended increasing the funding and improving the management of the remaining summer youth jobs programs. These programs could be linked to the private sector labor market, for example, through business improvement districts. She suggested using local employer consortiums to address the problem of job ladders. In such consortiums minimum-wage jobs would serve as training camps and proving grounds for workers. Employees who proved themselves would be "passed along" to employers who needed workers in better positions. Such consortiums link employers (who have interests and experiences in common and are likely to trust one another's judgments) rather than linking employees (who may have little knowledge about new jobs). They also remove the need for employee contacts in hiring.

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## Program Scholars

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

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

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

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

If the objective of policy is to increase the utilization of human capital and, therefore, economic activity so that every race, gender, education, and age group in the working-age population is working close to its capacity, then it is important to understand the aggregate level of underutilization and its distribution within

the working-age population. Does the greatest potential lie in reducing economic inactivity among younger or older workers, among males or females, or among less-educated or more-educated workers? The answers to these questions will indicate whether policies targeted at youths (such as Jobs Corps and youth employment policies), older workers (changes in Social Security and disability benefits), or young women (changes in welfare policy) are likely to be more effective in increasing economic activity. Haveman is the John Bascom Professor of Economics and Public Affairs at the University of Wisconsin, Madison; he received a Ph.D. from Vanderbilt University. Wolfe is a professor of economics, preventive medicine, and public affairs at the University of Wisconsin, Madison; she received a Ph.D. from the University of Pennsylvania.

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

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 firms—such as employment stability, investment, and collective bargaining—and 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, an 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 and on developing a methodology for analyzing public policy that relies on the application of political philosophy as well as cost-benefit analysis. Recently, he has been examining the effects of a change in the minimum wage, worker displacement due to plant closures, welfare reform and the potential for workforce development, and political realignment in the electorate. Levin-Waldman received a Ph.D. in political science from Temple University. He is the author of Public Policy Brief No. 21, *The Consolidated Assistance Program* ; No. 26, *Making Unemployment Insurance Work* ; and No. 31, *A New Path from Welfare to Work* . He also is the author of *Reconceiving Liberalism: Dilemmas of Contemporary Liberal Public Policy* (University of Pittsburgh Press).

Executive Director **Dimitri B. Papadimitriou** and Research Associate **L. Randall Wray** currently are conducting research to assess the effect of demographic shifts - specifically, the aging of the population - on the labor market in light of the current slow growth in labor force participation rates and based on different ranges of productivity growth. Papadimitriou and Wray will then evaluate the need to revise public policies concerning the retirement age, the Social Security program, and macroeconomic employment policies. They also will continue their work in the program on restructuring in the financial services sector on the appropriateness of using existing price indexes as targets for monetary policy, 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 America - Past and Present." The initiative focuses on the processes by which immigrants and their descendants are assimilated into U.S. economic life. It is hoped that this work will shed light on current policy issues related to immigration, such as international competitiveness, the labor market, income distribution, and poverty.

Perlmann is engaged in three research projects to further this initiative. The first, "The Jews Circa 1900: Social Structure in Europe and America," focuses on social characteristics that help explain the rapid socioeconomic rise of 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.

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## New Working Papers

### Taxes, Saving, and Macroeconomics

**Neil H. Buchanan**  
**Working Paper No. 177, November 1996**

Resident Scholar Neil H. Buchanan offers an analysis of the macroeconomic effects of current proposals to reform the tax system (for example, a flat tax or a national sales tax), focusing on the aspects of the proposals aimed at promoting saving.

Buchanan notes that a drawback in the way in which saving is officially defined is that only businesses (and not households) are assumed to make purchases that have long-term payoffs. That is, personal spending on items such as education and durable goods is defined as consumption when in fact it is investment in long-term economic well-being and therefore should be categorized as saving. The purest definition of saving would include all resources produced in the economy during the year "that are not consumed today but are put to use in a way that will provide returns to the economy in years to come." Consumption also should be redefined to include those items utilized, but not directly paid for by consumers, such as employer-provided benefits and the value of owner-occupied housing.

Another definitional problem in many analyses of the effects of saving is the exclusion of business saving from private saving despite the fact that business saving drives investment. Moreover, business saving is three to four times greater than personal saving, financing the bulk of investment in private capital. Since business saving has remained a relatively constant proportion of GDP and disposable income, inclusion of it in a definition of private saving would make it difficult to make an argument that additional private saving is needed.

Even if we accept the premise that personal saving should rise, the evidence is mixed on whether preferential tax treatment (either to reduce the cost of saving or increase the cost of consumption) will result in higher saving. Buchanan points out that since national saving includes government saving, the success of tax cut plans aimed at stimulating saving depends on private saving's rising by more than the dollar value of the tax cut (so that total national saving increases). Moreover, empirical evidence on the ability of tax changes to reduce consumption shows that, in the face of declines in income, households will reduce saving rather than reduce their standard of living. This, Buchanan concludes, means that for saving policies to succeed, they must alter behavior as income rises rather than attempt to reallocate current (or lower) levels of income, which also implies enacting policies aimed at stimulating economic growth.

What then are the macroeconomic implications of a policy successful at increasing national saving? The neoclassical model argues that a direct causal relationship between private saving and private investment exists via the effect of saving on interest rates. Buchanan states that such reasoning is mistaken on several counts. First, the assumption of an inverse relationship between saving and interest rates is false because overall liquidity determines interest rates, a factor under the influence of Federal Reserve action. Second, the assumption that interest rates (or, more broadly, the cost of capital) have a strong effect on investment is questionable given the weak empirical evidence in its support and other evidence that the state of the economy is a stronger determinant of investment than the cost of capital. Moreover, most investment in plant and equipment is not financed with external (borrowed) capital, but with internal funds. Therefore, tax policies that aim to reduce interest rates by increasing national saving (much less personal saving) will have little or no effect on plant and equipment investment. Finally, even if all of the variables were affected in the direction surmised by the neoclassical model, the amplitude of those changes would have to be large to have an appreciable effect on GDP growth rates. Buchanan estimates that the personal saving rate would have to rise to 16.5 percent (compared to a 6.5 percent average over the last 30 years) and the total rate of private saving would have to climb to 50 percent (compared to the 16.1 percent posted in early 1995) to raise the GDP growth rate by one percentage point (from 2.5 percent to 3.5 percent).

Buchanan, arguing that fiscal and monetary policy are "inseparable" in any discussion of the macroeconomy, notes that it is not known how the Federal Reserve would react to the implementation of a tax policy aimed at increasing saving. If the policy were unsuccessful and induced a contraction, the Federal Reserve might not attempt to counteract fully the effect of the tax policy in hopes of getting closer to its goal of zero inflation. If the policy were successful and increased the long-term growth rate of the economy, the Fed might attempt to stifle the increase in growth because of the long lag in recognizing changes in potential growth rates. Buchanan concludes that "saving-inducing tax plans are attacking a problem that does not exist, with a mechanism that will not work, in order to achieve a goal that would harm the economy."

## **The New Welfare: How Can It Be Improved?**

**Oren M. Levin-Waldman**  
**Working Paper No. 184, January 1997**

Resident Scholar Oren M. Levin-Waldman compares the old and new welfare laws, assesses some of the possible effects of the new law, and provides policy prescriptions for how to combine existing welfare programs, job training programs, and the unemployment insurance system to achieve a more comprehensive and coherent employment program that meets individual needs and provides public services more efficiently.

The "old" welfare system was composed of a number of programs, including Aid to Families with Dependent Children (AFDC), Medicaid, and food stamps. AFDC originally was designed to allow widows to stay at home and care for their children. Benefits were seen as a form of temporary income maintenance. The federal government set minimum benefit levels and provided 55 percent of program funding. States financed the remaining 45 percent of program costs and had the option of setting benefit levels higher than the federally defined minimum.<sup>(1)</sup> This form of finance made AFDC an entitlement program. The design of the program also created disincentives to work or marry because earned income was offset by a corresponding decline in benefits. Levin-Waldman notes, however, that even under the old system, states were free via the waiver process to design programs that might reduce such disincentives. The stated purpose of the "new" system is to encourage responsible parenthood, marriage, and the family. Federal law sets limits on the maximum amount of time a person can receive benefits and sets minimum work requirements (states can set more stringent time limits and work requirements). The federal portion of funding is provided to the states through block grants that are subject to an annual appropriations process. This effectively ends welfare's entitlement status. States may develop their own programs, although these programs are subject to a variety of federal regulations.

How will the new welfare legislation affect poverty and employment? Levin-Waldman notes that there is no consensus on the immediate effects of the law, but supporters claim that it will allow states to develop programs better suited to their needs. He reviews three programs already in place through federal waivers - those in Wisconsin, Massachusetts, and Minnesota - as examples of what states have done. Although the three programs differ, they are similar in attempting to "break the poverty culture" by adopting work-based programs. There are some problems with these programs. The work-based programs make use of employer subsidies, and although former welfare recipients would presumably receive the training and experience that the subsidies provide for them (thereby making them better able to compete in the labor market), the question



remains whether jobs would be available after subsidies run out. Moreover, implementing a program such as the Wisconsin plan nationwide would cost considerably more than is currently spent on welfare programs.(2) Implementation could be further hampered by the fact that federal spending is supposed to be frozen at \$16.4 billion through 2004. States, especially those in which welfare costs are high, would be hard-pressed to maintain current benefits should there be a recession or change in demographics.

What of the effects of the new law on poverty? Critics of the new system argue that it will push more people, especially children, into poverty. According to Levin-Waldman, the new law reflects a "belief that those on welfare have different behavioral traits than those considered to be part of the mainstream middle class." Research on poverty is divided into economic and behavioral schools of thought. The economic arguments - buttressed by much of the human capital and wage gap literature - assert that welfare recipients are poor because they do not have the skills necessary to obtain a job that pays much more than the minimum wage and there is an insufficient number of better-paying jobs. Recipients act rationally by remaining on welfare because they receive benefits such as health care that they would not receive at such low-paying jobs and the jobs they can obtain will not lift them out of poverty. Accordingly, poverty would be reduced in a growing economy in which more and better-paying jobs were available. If this is the case, it is difficult to see how the new welfare law will help alleviate poverty. The behavioral school suggests that people are poor because they lack a work ethic. If this is the case, then the new law will force recipients to look to sources other than welfare for subsistence. Levin-Waldman suggests that poverty stems not from a single cause, but from a combination of factors cited by both schools of thought.

Because of the new emphasis on moving welfare recipients to work (as opposed to subsidizing mothers to stay at home with their children), Levin-Waldman suggests eliminating the artificial distinction between welfare and employment programs. Unemployment offices should eliminate the distinction between those who were recently laid off and those who have been on welfare and both groups should be matched to training programs that would best meet their needs. Such matching is now done within the unemployment insurance (UI) system, which profiles and identifies individuals seeking UI benefits who are most likely to experience long-term unemployment; these individuals are then targeted for job search assistance. Existing unemployment, welfare, and job training bureaucracies could then be combined (although they may be administered separately by the states). Levin-Waldman suggests that it may be necessary to offer subsidies to encourage employers to hire some individuals.

Levin-Waldman concludes that the combination of welfare reform with workforce development and unemployment insurance is logical given the change in the goal of welfare to foster a greater work ethic. The combination also would lead to greater efficiency in service delivery and end the stigma attached to welfare.

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## Notes

1. The states' option to set benefits resulted in a variation in AFDC benefits from state to state. Because food stamp benefits were based on income (including AFDC benefits), they reduced some of the disparities in AFDC benefits among states.
2. Levin-Waldman estimates that even if legal immigrants continue to be denied participation in such programs, the cost of a nationwide implementation of the Wisconsin plan would total \$67.5 billion, as compared to the combined federal and state spending of \$48 billion for the old AFDC, JOBS, and food stamp programs.

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## 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 infra-structure 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 Ph.D. from the University of Rochester. He is the author of "Public Capital and Economic Growth" in Public Policy Brief No. 4, *Public Infrastructure Investment: A Bridge to Productivity Growth?*

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. He is examining the macroeconomic consequences of proposals to revamp or replace the federal income tax system, with an explicit analysis of the effect of such tax changes on the national saving rate. 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 Municipal Assistance Corporation (MAC) for New York City and is a member of the Levy Institute Board of Advisors. He is the author of Public Policy Brief No. 16, *Infrastructure Investment for Tomorrow* .

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## ASSA Session on the Work of Hyman P. Minsky

A session entitled "The Contributions of Hyman Minsky" was held at the annual meeting of the Allied Social Science Association in New Orleans. The Levy Institute distinguished scholar, who passed away in October, was to have chaired the session. Seven papers that drew on various aspects of Minsky's lifetime research were presented. The session was moderated by Executive Director Dimitri B. Papadimitriou. Below are synopses of portions of the presentations.

### **"The Institutional Prerequisites for Successful Capitalism," by Dimitri B. Papadimitriou and L. Randall Wray**

This paper by Executive Director Dimitri B. Papadimitriou and Research Associate L. Randall Wray, of the University of Denver, was presented by Wray. The paper focuses on Minsky's financial instability hypothesis (FIH), his explanation of forms of capitalism, and some of his lesser-known policy proposals. According to the FIH, financial positions evolve from hedged to speculative to Ponzi, as expectations about future returns become increasingly optimistic. When expectations are not met, financial arrangements are disrupted. Apparent financial stability generates changes in expectations, and these changes in turn lead to the adoption of financial positions that cannot be validated should events prove to be less favorable than expected. The FIH depends critically on the form of institutional arrangements and on the evolution of behavior given these arrangements.

From his earliest publications Minsky realized the importance of explaining new forms of capitalism. For Minsky the defining characteristic of the Great Depression was not the 50 percent decline in GNP or the 25 percent unemployment rate, but the 85 percent drop in financial asset value precipitated by the absence of aggregate profits. As most financial debts and assets were wiped out, balance sheets were simplified, which allowed the financial system to emerge with "simple," or robust, balance sheets with little leveraging and with most assets in the form of equity positions.

Since the Great Depression, balance sheet simplification has not occurred again despite the persistence of the business cycle. Another great depression has not occurred because ceilings and floors in the form of a variety of institutional arrangements, both public and private, have successfully prevented a debt deflation. (According to Minsky, two of the most important of these are a big government capable of running large countercyclical deficits and surpluses to sustain and constrain demand, and central bank intervention as lender of last resort to place a floor on asset prices.) Minsky emphasized that if debt deflations are eliminated, increasingly fragile positions can be taken without simplification's taking place; other institutional arrangements must therefore be adopted to constrain expectations regarding asset prices.

The New Deal and later reforms led to the development of a successful form of capitalism, but the institutions

that favored that form of capitalism became increasingly ill-suited to deal with the form that developed after the 1970s. From these thoughts stemmed Minsky's anti-laissez-faire theorem: New institutions and interventions are imposed to replace the endogenously determined variables that generate incoherence. These new institutions and interventions create new initial conditions that largely determine the extent to which the path of the economy through time is tranquil or turbulent; progressive, stagnant, or deteriorating. Apt intervention and institutional structures are necessary for market economies to be successful.

Papadimitriou and Wray also discuss some of Minsky's lesser-known policy recommendations. Minsky advocated a number of policies to stem growing inequality, poverty, unemployment, and concentration of power, such as reordering spending priorities toward employment programs, child allowances, and public infrastructure and away from defense and transfers to the non-aged. He believed an employment program could substitute for most transfers, which he believed imparted an inflationary bias to the economy. In order to avoid imposing such a bias, he advocated shifting government spending away from programs that would raise only demand to programs that would increase both demand and supply, such as spending on public infrastructure development and workfare. Minsky thought most taxes to be inflationary because they add to cost. Moreover, he thought that the payroll tax encourages substitution of capital for labor. He therefore advocated eliminating corporate income taxes and the employer portion of the payroll tax. He also supported greater use of excise taxes that attempt to influence behavior, such as a larger tax on petroleum, a broad-based VAT as a backdoor tariff, and export subsidies on imports and rebates on exports.

Minsky also wished to remove various impediments to labor force participation and to ensure there was work for all. He argued that many transfer programs provide significant barriers to work fully and advocated reforms replacing AFDC with a universal children's allowance, eliminating wage income constraints, and extending the retirement age for Social Security. To ensure full employment, he proposed that the government act as employer of last resort at some minimum wage. Because government-guaranteed jobs would pay less than private sector jobs and because they would increase potential output, they would not place significant pressure on private sector wages or on prices. Moreover, in the current system wages must be high enough to induce those receiving transfers to accept employment; in Minsky's system the alternative to private employment is government employment, and, as long as the government wage is not frequently increased, it could act to dampen wage increases. Thus his system has less potential for inflation than the current system. Cyclical fluctuations in private sector employment would be offset by changes in the proportion of government-employed workers.

Minsky's industrial policy favored smaller firms because, being less able than large firms to finance long-lived capital, they tend to use more labor-intensive techniques. While he agreed with the orthodox belief that competitive markets promote efficiency, he acknowledged that market power is not equally distributed and that externalities exist. Government regulation may be necessary to constrain the exercise of power, promote competitive industry, facilitate financing, and aid the development of a trained and productive labor force. However, he saw industrial policy as an alternative to antitrust legislation, which he believed fails because it cannot create the conditions required to permit smaller firms to prosper. Breaking up large firms does no good if small firms cannot survive in the resulting environment. Minsky advanced these and other policies to help create the institutions necessary for a form of capitalism that he believed would be successful.

### **"The Role of Margins of Safety and Weight of the Argument in Generating Financial Fragility," by Jan Kregel**

In his presentation, Jan Kregel, of the University of Bologna, noted that economists have offered a number of explanations of the creation of financial instability. Kregel reviewed two of them - asymmetric information and rational bubbles; gave the explanation of it offered by Minsky and illustrated how his explanation might be subject to misinterpretation; and offered an alternative explanation built on Minsky's approach to probability and expectations.

According to Minsky's concept of financial fragility, a bank's margin of safety offers the bank protection against unforeseen events and substantiates that past performance is not a conclusive predictor of future actions by the borrower. Over the course of the business cycle, margins become so small that the slightest departure from the expectations on which the margins are based can disrupt the plans of both the borrower and the banker as set out in a borrowing agreement. One explanation of how margins can be eroded is asymmetric information: the borrower attempts to misrepresent to the banker the basis of the pro forma statement. (Minsky did on occasion express his ideas in terms of increasing optimism or excess euphoria on the part of both borrowers and lenders in striking agreements to finance projects.) Kregel believes that if asymmetric information does exist, it is likely in the opposite direction, that is, in favor of the banker. Minsky also believed bankers are extremely skeptical and take precautions to assure that credit risks are evaluated properly,

which for Kregel makes the asymmetric information argument unconvincing as an explanation of declining margins of safety. A second explanation of margin erosion is the rational bubble, that is, rational expectations produce a certain degree of euphoria that allows margins of safety to be reduced. Kregel also finds the rational bubble argument unconvincing. According to this explanation, everyone's sharing the same type of expectations results in an autogenerative process leading to euphoria. However, Minsky's belief in bankers' skepticism suggests that even if they are subject to euphoria, they still will tend to pull back when others are expanding; this reasoning therefore does not explain how margins of safety erode.

Kregel suggests a different explanation of how both bankers and borrowers convince themselves, on perfectly rational grounds, that they are continuing to engage in activities that have a constant and sufficient margin of safety when, in fact, the system is becoming increasingly fragile. Assuming that bankers are no better than anyone else at evaluating future events (the sort of assumption made by Minsky), then the best way to explain bankers' actions is to say that bankers will extend credit to individuals for projects if the individuals are perceived as good credit risks (determined by past actions, that is, by their repayment history) and if it is expected that the projects will be profitable (determined in large part by expectations of future events). But although bankers have information on which to base their expectations about credit risk, they have little information about project risk. Keynes observed that people tend to fall back on convention when little is known about the future. Applied here, this observation means that bankers gauge project risk by looking at the types of projects that other bankers are lending for and follow suit. During an expansion, then, the credit histories of all borrowers improve, resulting in increased repayment probabilities in the evaluation by bankers of both credit and project risks. As the expansion continues, the successful experience of both borrowers and lenders leads them to believe that their past successes can substitute for margins of safety normally imposed on lenders. Confidence rises and probabilities associated with successful repayment rise. It takes only a small reversal to shake optimism and create instability.

### **"At the Root of the Financial Instability Hypothesis: Induced Investment and Business Cycles," by Domenico Delli Gatti and Mauro Gallegati**

The third paper, by Domenico Delli Gatti, of Catholic University in Milan, Italy, and Mauro Gallegati, of the University of Teramo, Italy, was presented by Gary Dymksi, of the University of California at Riverside. The paper evaluates the research project "Induced Investment and Business Cycles" outlined by Minsky in his 1954 Ph.D. dissertation and assesses the extent to which his subsequent writings develop or deviate from the dissertation. In particular, Delli Gatti and Gallegati look for the roots of the financial instability hypothesis. They find that Minsky's approach cannot be traced to one specific source. While incorporating many Keynesian features, he goes beyond Keynes to examine agents' interaction as the root of the aggregation problem. For Minsky finance matters because agents are heterogeneous and changes in their balance sheets drive fluctuations. Like Schumpeter, he emphasizes that market structure affects investment and that it changes during the cycle.

In his dissertation, Minsky laid the building blocks of his financial instability hypothesis, such as the concept of the two-price system, the relevance of balance sheets, the notion of lender risk, and insights about the variability of a firm's financial soundness. The FIH was then not an autonomous piece of analysis, but rather a component of business cycle theory. At that time the dominant framework for business cycle analysis was the accelerator model, either Samuelson's linear version of the model or the nonlinear version suggested by Hicks and Goodwin. Having discarded the linear approach because it relied on exogenous, unexplained impulses, Minsky also criticized Hicks's ceiling and floor solution because it analyzes macro relations without any reference to interaction among different kinds of agents and because it neglects financial connections among heterogeneous agents. Minsky's Keynesian view is that induced investment demand induces economic fluctuations. Going beyond Keynes, he also believes that the interaction of heterogeneous firms and ever-changing markets modifies investment activity. The aim of Minsky's thesis, then, is to build a complete model of the business cycle that includes the relationship between the value of the accelerator coefficient and (1) the structure of the market and (2) the behavior of financial markets and how this relationship makes the accelerator effect procyclical.

In the traditional accelerator model, firms face no financing constraints. In Minsky's dissertation, agents are heterogeneous but can be classified according to their balance sheet positions, which, in turn, are strongly related to the business cycle. Minsky detects three main financial constraints to investment demand: (1) the difficulties faced by new firms in acquiring equity, (2) the effect on firms of financial tightening, and (3) deteriorated financial conditions that are a consequence of an accelerated expansion of operations and a result of a rising rate of capital expansion. Firms can be forced to use their earnings to repay debt, causing the proportion of retained profits devoted to increasing equity to decline. Debt therefore rises as the cycle moves along, meaning that the realized accelerator coefficient is procyclical.

In his dissertation, Minsky distinguishes between wholly owned firms and firms with a large volume of debt with widely different liability structures. The definitions of hedge, speculative, and Ponzi financing are still far away, but we can recognize the familiar classification. Firms' survival rate depends on two conditions: liquidity (the ability to pay debts) and solvency (the ability to maintain net worth). If a firm does not meet the solvency condition, it goes bankrupt and leaves the market. The entry process is therefore linked to a real financial element: the survival condition. This process changes the degree of competition in real and financial markets and the number, size, and distribution of firms, making cycles differ from one another.

Minsky's dissertation contains the basic ingredients of the financial instability hypothesis and points out how interaction between firms determines aggregate behavior. The real approach to market imperfections outlined in the thesis was given up by the mature Minsky,<sup>(1)</sup> who adopted Kalecki's theory of profits and Keynesian aggregate demand theory. As far as the real part of Minsky's framework is concerned, there has been a shift from microanalysis to macroanalysis. It is also clear that a stock market crash is not the cause of a financial crisis. A crash might exacerbate a crisis and often is a consequence of a crisis, but the financial fragility of the system does not require it.

### **"Deciphering Minsky's Wall Street Paradigm," by Gary Dymksi**

In the presentation of his own paper, Dymksi noted that for Minsky there were three points fundamental to understanding Keynes: the cyclical character of a capitalist economy's movement through time, the notion of uncertainty, and the crucial role of investment in linking real outcomes with unstable financial processes. In Minsky's view, Keynes missed "the endogenous generation of booms, crashes, and debt deflation," but this missing element can be added by acknowledging, first, that the basis of future events is uncertain and, second, that this uncertainty affects investment decisions, specifically through financing decisions. According to Keynes, investment is affected by uncertainty through entrepreneurs' having to make their own assessments of borrowers' risk and their own prospects. Minsky adds to this two other aspects of uncertainty. First, financing commitments will remain even if the investment project fails; second, financing commitments must be obtained in competition with other financial asset choices that may, in turn, be affected by perceptions about uncertainty. Minsky also criticized the neoclassical synthesis by noting that while it accepted from Keynes the possibility of persistent unemployment, it rejected the idea that "a capitalist economy with sophisticated financial practices is inherently unstable."

Dymksi discussed three elements of Minsky's Wall Street paradigm that are somewhat blurred because of some ambiguities on Minsky's part. The first element is the term "Wall Street," which Minsky uses in two ways. On the one hand, he means the whole speculative financial paradigm; on the other hand, he means a set of practices, markets, and agents. The second element is the concept of financial fragility, which Dymksi understands as the microtheoretic account of firms' balance sheets as they evolve from robust to Ponzi, a theory of the financial fragility of the representative firm. Dymksi noted that this can be somewhat ambiguous because in one or two instances Minsky failed to label his microlevel analysis as such. Financial fragility can be a convenient term to describe the state of balance sheets at a point in time, but Minsky never labeled it specifically in this way. As a result, the line between macro- and microanalysis gets somewhat blurred. The third element is the term financial instability, which essentially is a dynamic form of the idea of financial fragility. By it, Minsky means changes in cash flow relations that occur over a run of good or tranquil years and that transform an initially robust financial system into a fragile one.<sup>(2)</sup>

Dymksi then turned to three misconceptions about the Wall Street paradigm. First is the reduction of the hypothesis to "Capitalist economies produce financial manias driven by irrational expectations that eventually induce financial crashes and then depressions." This reduction is inaccurate because it leaves out Minsky's ideas that the cycle had been changed by the introduction of government stabilizing expenditures and by lender of last resort interventions by the Fed and that a crash is not necessary to precipitate an economic turning point.

The second misconception is confusing Tobin's Q with Minsky's two-price system. According to Minsky, investment can be priced according to financial markets' assessment of how much a given capital asset is worth or by the real production cost of generating that asset. The capital market assessment price can change quickly, while the production price changes slowly, so the two prices can get misaligned. Moreover, the ratio of these prices is an indicator of the degree of financial speculation taking place. Tobin's Q is an equilibrium concept in which Q plays a key role in a behavioral theory of investment. Although Minsky's writing sometimes made it appear that he believed this equilibrium theory to be a determining factor in investment, Dymksi doubted that Minsky could have meant such a thing.

The third misconception is that the financial instability hypothesis requires agent irrationality. Dymski opined that New Keynesians have tried to salvage Minsky by suggesting that he shows how finance matters, but they insist that he needs irrationality to show it. They therefore feel it necessary to subtract the irrationality and add other aspects, such as asymmetric information, to get to financial instability, which Dymski felt was incorrect.

### **"Rethinking Bank Examinations: The Minsky Approach," by Ron Phillips**

The fifth paper was presented by Ron Phillips, of the Office of the Comptroller of the Currency and Colorado State University.(3) Phillips stated that federal bank regulators have called for a new approach to bank examinations that would focus on evaluating an institution's quantity of risk exposure and determining the quality of the risk management system to control that risk. Discussion of such an approach to examinations echoes some of the concerns put forward by Minsky 30 years ago in regard to a cash flow– oriented bank examination. In his paper, Phillips presented the traditional approach to bank exams, reviewed recent proposals for revising the exams, and compared these proposals with Minsky's proposal. He finds that although there are some similarities between the new proposals and Minsky's proposal, there are fundamental differences, which hinge on the financial instability hypothesis.

The traditional approach to bank examinations is based on the belief that some bank activities are a public good, which justifies making banks subject to prudential supervision by regulators carried out through periodic bank examination. The five critical aspects of this examination are summarized as the bank's CAMEL rating: capital adequacy, asset quality, management and administrative ability, earnings level, and liquidity level quality. Banks are rated from one to five (one the best rating) in each category, compared with other banks, and assigned a composite CAMEL rating.

This method of bank regulation and supervision is being questioned. Thomas Hoenig, president of the Federal Reserve Bank of Kansas, recommends strengthening the stability of the financial system by designing procedures that prevent large interbank exposures in payment systems and interbank deposits instead of the current method of regulating individual institutions in an attempt to make them fail-safe.

According to the proposed changes in bank examinations, first, banks should be viewed as customers of regulatory agencies, with regulatory agencies facilitating, rather than supplanting, the operation of market forces; regulation and supervision should therefore add value to firms. Second, the microeconomic conditions of a bank should be viewed in a macroeconomic perspective, integrating the work of examiners and economists.(4) Such changes appear to be broadly consistent with Minsky's views. The central message of his 1957 paper "Central Banking and Money Market Changes" was that over time the initially apt pattern of regulation and supervision becomes increasingly inept. In 1975 Minsky presented his proposal for flow-oriented bank examination in a paper at the Chicago Federal Reserve Bank's annual bank structure conference. His method was intended to generate information on an institution's liquidity and solvency (as opposed to fraud and oversight), force central bankers to become aware of ongoing institutional changes, and point to the need for the Fed to act as lender of last resort. The 1995-96 examination forms reflect a recognition of what Minsky pointed out in 1957, namely, that banks are position takers and information on their liabilities is crucial in making regulatory authorities aware of potential financial crises.

The view today among many regulators is that market discipline can be heavily relied on to promote safety and stability in the financial system. Minsky would be more reluctant to rely on such forces as a substitute for regulation and supervision. In an unpublished paper, he stressed that the structure of regulation and supervision might be ever-evolving because of the changing nature of "appropriate" structures over time. According to the FIH, financial innovation will continually generate conditions that require intervention by the central bank to mitigate crises. Phillips stated his belief that Minsky's work is a valuable starting point for rethinking bank regulation and supervision.

### **"Money Manager Capitalism and the End of Shared Prosperity," by Charles J. Whalen**

Charles J. Whalen, of Cornell University, presented a paper that he wrote with Minsky while Whalen was a visiting scholar at the Levy Institute.(5) The form of capitalism in place in the United States at the end of World War II produced nearly a quarter century of economic growth, relative stability, and shared prosperity. Today's capitalism is what Minsky terms "money manager capitalism." Minsky and Whalen's paper traces the development of Minsky's ideas on postwar structural change. The first part describes Minsky's debt to his dissertation supervisor, Schumpeter, in producing a historical account of capitalist development. That account focuses on the changing relations between finance and business and identifies a number of stages in the development of today's money manager capitalism. The second part outlines Minsky's conception of the

current era, a period dominated by money managers, mutual fund managers, and other institutional investors. The third part discusses the connection between the development of the current form of capitalism and the end of shared prosperity, suggesting that money manager capitalism and the rising economic insecurity experienced by many Americans are two sides of the same coin.

### Untitled paper, by Victoria Chick

The session's final paper, by Victoria Chick, of University College London, was read by Jan Toporowski. Chick found Minsky to be equally at home among practicing bankers, financiers, and academics. She was profoundly influenced by Minsky's concept of the importance of financial institutions in macroeconomic theory. She went on to show that it was the development of financial institutions that underpinned the causal priority of investment over saving, because credit, being a means of payment and generally acceptable, can be created in the system without a constraint on saving. A problem arises in a system in which credit is used to finance investment when investment expands too rapidly. Chick sees this problem as one of the factors contributing to the instability of the postwar economic system. Her view is challenged by those who say that investment is largely funded from retained funds and that only marginal projects, a small proportion of total investment, tend to be financed from borrowed funds. Chick interprets the internal funding view as a backdoor through which to reintroduce the notion that saving determines investment. She also argues that there has been a rise in financial fragility because, in the presence of a lender of last resort, reserves no longer play any effective prudential role. The securitization of banking also limits the role of reserves. Fragile financing structures are now being used to finance autonomous expenditures (such as consumer loans, property deals, mergers, and takeovers), which have nothing to do with expanding productive capacity. This new financial fragility means that the present system is actually far more threatening than the system described in Keynes's General Theory, in which there was a degree of instability due to the volatility of investment and problems arising out of uncertainty.

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### Notes

1. Delli Gatti and Gallegati characterize the "mature" Minsky as the author of *John Maynard Keynes* (1975) and *Can 'It' Happen Again?* (1982).
2. In his later essays Minsky sometimes referred to this financial instability hypothesis as the Minsky hypothesis and sometimes renamed the Wall Street paradigm the financial instability hypothesis. In the remainder of Dymski's paper, he refers to the idea (the microanalysis of financial fragility and the dynamic macrohypothesis about the evolution of fragility over the cycle) as the Wall Street paradigm.
3. Phillips noted that although his paper was written while he was a visiting scholar at the Bank Research Division of the Office of the Comptroller of the Currency, the views expressed in it are his and not those of the OCC.
4. A fundamental change in the bank examination procedures of both the FDIC and the OCC during the last several years has been to send Ph.D. economists on all major bank exams.
5. This paper was published as Levy Institute Working Paper No. 165.

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## Program Scholars

Research Associate **Steven M. Fazzari**'s current project (which also falls into the area of federal budget policy) 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 rates - such as tax incentives, budget deficits, and saving incentives - are 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 condition - either through internal cash flow or through external debt - could 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. He is the author of Public Policy Brief No. 9, *The Investment-Finance Link*, and, with Benjamin Herzon, No. 25, *Capital Gains Taxes and Economic Growth*.

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

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## Program Scholars

Two accounting-based models form the foundation of much of Distinguished Scholar **Wynne Godley's** research. The first model, the Levy Institute model, tracks the evolution of the U.S. economy using a consistent system of stocks and flows (such as income, production, and wealth). This system of information makes it possible (1) to identify significant trends and magnitudes, suggest policy responses to problems, and gauge economic outcomes and (2) to assess the economic implications of different policy regimes. Godley's findings are to be published as an annual Levy Institute publication. The second model, originally developed at Cambridge University, is a "closed" world model in which 12 trading blocks - of which the United States, China, Japan, and Europe are four - are represented. This model is based on a matrix in which each block's imports are described in terms of exports from the other 11 blocks. From this information and using alternative assumptions (for example, about growth rates, trade shares, and energy demands and supplies), past trends can be identified and the patterns of trade and production analyzed to reveal any structural imbalances. With Research Associate George W. McCarthy Jr., of Bard College, and Gennaro Zezza, of the Institute Economic, Financial University Degli, Godley is writing an economics textbook, tentatively titled *Stock-Flow Economics*. The book is based on a number of models, including a theoretical model as well as the U.S., U.K., and world models. Godley was a member of HM Treasury's Panel of Independent Forecasters, the so-called Six Wise Men. He is professor emeritus of applied economics at Cambridge University and a fellow of King's College. He is author of Public Policy Brief No. 23, *A Critical Imbalance in U.S. Trade*.

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 for Europe's policymakers, he will examine the effects of asymmetric shocks on individual regions in the wake of monetary union.

Cambridge University Visiting Scholar **Susannah Rodgers** is examining 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 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.

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# New Working Papers

## **What Do Micro Data Reveal about the User Cost Elasticity? New Evidence on the Responsiveness of Business Capital Formation**

**Robert S. Chirinko, Steven M. Fazzari, and Andrew P. Meyer**  
**Working Paper No. 175, November 1996**

The responsiveness of business investment to user costs (interest rates, taxes, and depreciation rates) is important in determining the effect of fiscal policy and aggregate stabilization policy on the economy and for assessing the transmission mechanism of monetary policy to real economic variables. Although this responsiveness is central to the theoretical underpinnings of most economic models, empirical support for substantial responsiveness is lacking. In this working paper, Robert S. Chirinko, of Emory University; Research Associate Steven M. Fazzari, of Washington University in St. Louis; and Andrew P. Meyer, of the Federal Reserve Bank of St. Louis, use micro data to evaluate the user cost elasticity (UCE) of capital.

The authors employ data obtained from the Compustat database on investment, cash flow, and sales for 4,112 firms for 1981 to 1991. They merge this with industry-level data obtained from Data Resources, Inc., on the user costs of 26 different capital assets variables. Unlike other studies in which user cost variables vary only over time and not across firms, Chirinko, Fazzari, and Meyer's user cost variables vary in both time-series and cross-sectional dimensions. The large number of firm-level observations in the Compustat data increase the precision of the estimates and allow a given parameter to be estimated over a relatively short time frame. The data also help to address questions of biases not easily dealt with when using aggregate time-series data.

Chirinko, Fazzari, and Meyer employ a distributed lag model in which the optimal capital stock is a function of the level of sales and the user cost of capital. They assume a constant elasticity of substitution between capital and variable inputs and a constant geometric depreciation rate. Investment demand is divided between investment for replacement purposes and a net component, both scaled by the existing capital stock. The net investment ratio - the change in the capital stock between periods  $t - 1$  and  $t$ , scaled by the existing stock - (plus one) is assumed to adjust according to the weighted geometric mean of relative changes in the desired stock of capital. The authors find that "the effects of liquidity [measured as cash flow] on investment expenditures are short-run, perhaps distributed over several periods."(1)

To check for bias, the authors subjected their results to a number of tests and estimated the UCE using alternative models. The results of a mean-difference estimate (to account for firm fixed effects(2)) indicate that some bias is introduced by the assumption of firm homogeneity; such bias could be part of the reason for difficulty in finding negative UCE estimates from aggregate data. To control for simultaneity arising from aggregate shocks, aggregate time dummies were included in mean-difference, first-difference, and long-difference regressions. The absolute value of the UCE estimate fell substantially in the time-dummy regressions, leading Chirinko, Fazzari, and Meyer to conclude that "aggregate simultaneity appears important, but it has the opposite effect on the UCE than has been often assumed." Instrumental variables (IV) estimates were derived to account for possible simultaneity arising from correlations between the investment error term and micro-level regressors. To get around the problem of using instruments that, although predetermined, are not strictly exogenous (as is the case with mean-difference estimators when using undifferenced lags of the regressors as instruments), the authors employ an orthogonal deviation transformation for panel data, which subtracts the mean of future observations from each regressor. Hausman tests indicate that consistent estimates require using instrumental variables. Point estimates of the UCE range from the first-difference value of -0.060 to the orthogonal deviation estimate of -0.557. Relatively large standard errors of the estimate of the UCE, however, lead the authors to examine the estimates of the individual lag coefficients. They find that most coefficients of lags of three or more years are insignificant. Limiting the number of lags to two years results in a significant decline in the standard errors. Estimates are smaller in absolute value than typically have been assumed in applied policy analysis. (The range in the point estimates of the UCE across estimators is between -0.176 and -0.249 - far different from the unitary value assumed in studies employing Cobb Douglas production functions.)

To assess the relevance of the "Lucas critique" of econometric policy analysis for their findings, Chirinko, Fazzari, and Meyer also test whether the Tax Reform Act of 1986 had an empirically significant effect on their estimates of the UCE. They cannot reject the null hypothesis that the UCE was stable over the period during which tax reform was anticipated and put into effect (1985 to 1989).

The authors use their model to estimate the effects of two tax proposals - a reduction in the capital gains tax rate and the flat tax proposal - on the user cost of capital. Reducing the capital gains tax rate from 28.0 percent to 19.8 percent results in a 0.47 percent increase in the long-run capital stock and a 0.14 percent rise in the long-run level of output. The estimated effects of enacting a flat tax are more substantial. Passage of the Hall-Rabushka flat tax proposal would raise the long-run capital stock 3.5 percent and boost long-run output 1.1 percent. These estimates of the effects of a flat tax, however, are substantially less than those of others who base their predictions on a unitary UCE.(3)

Chirinko, Fazzari, and Meyer conclude that their (lower) estimate of the UCE implies that models that rely heavily on prices to allocate capital may be misspecified and that the effects of the traditional monetary transmission mechanism and of tax policies aimed at stimulating capital formation will likely be weaker than previously thought.

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## Notes

1. If financing constraints had a long-run effect on the optimal stock of capital in the current period, cash flow would enter as a percentage change. However, the authors find "no evidence that the percentage change in cash flow has any positive effect on investment."

2. Based on their results, the authors rejected the use of pooled models and a random effects model (tests implied that estimates were inconsistent due to correlation between the firm effects and regressors); they therefore restricted their subsequent attention to fixed-effects models.

3. For example, Auerbach estimates that enactment of the Hall-Rabushka proposal would increase long-run per capita output 8.4 percent. Moreover, Chirinko, Fazzari, and Meyer's estimates are about one-third the size of those predicted by Hall and Rabushka. See Alan J. Auerbach, "Tax Reform and Adjustment Costs: The Impact on Investment and Market Value," *International Economic Review* 30 (1996): 939-962; and Robert E. Hall and Alvin Rabushka, *The Flat Tax*, 2d ed. (Stanford, Calif.: Hoover Institution Press, 1995).

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## Program Scholars

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

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

Kris Feder is an assistant professor of economics at Bard College. Her areas of specialization are public sector economics and history of economic thought. She received a Ph.D. in economics from Temple University. Michael Hudson is a visiting scholar at New York University. He received a Ph.D. in economics from New York University. Feder and Hudson are co-authors, with G. J. Miller, of *A Philosophy for a Fair Society* , published by Shephard-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.



























































