



Report

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SAVING SOCIAL SECURITY FROM THOSE WHO WOULD “SAVE” IT

THOMAS L. HUNGERFORD

Like a recurrent nightmare, the Bush administration, apparently emboldened by its success in getting Congress to start down the road to privatizing Medicare, seems ready to resurrect its proposals to privatize Social Security. Senate Republican Lindsey Graham recently introduced the Social Security Solvency and Modernization Act, which, among other things, would create private Social Security accounts. Not only would this prove disastrous to one of the nation’s most successful federal programs, but it simply isn’t necessary. The Social Security system certainly faces some challenges in the coming years, but nothing of the magnitude that warrants this private sector evisceration.

Arguing that Social Security is facing a serious long-term financing crisis, the Bush administration and some in Congress want to allow workers to divert part of their Social Security payroll taxes into private individual accounts modeled on 401K pension accounts or Individual Retirement Accounts (IRAs). Social Security retirement payments will then consist of a greatly reduced traditional Social Security benefit plus the proceeds from the individual account. The administration claims this will not only strengthen Social Security, but that workers will also receive higher benefits at retirement. In the first instance, the administration is completely wrong, and in the second, it is mostly wrong.

The claim that Social Security is facing a long-term financing crisis comes from the 2003 Social Security Trustees’ report, which projects that the Social Security trust fund will be exhausted in 2042 and only 75 percent of promised benefits can be paid thereafter. This projection is based, of course, on economic and demographic assumptions that may or may not

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prove accurate (for example, the projected exhaustion year has varied between 2029 and 2042 over the past 10 years). Not only is it questionable that this projection constitutes a crisis, but privatization would not, under any circumstances, save Social Security. Current Social Security payroll taxes are used to pay benefits to current retirees. If some portion of the Social Security payroll tax of current workers were diverted to private accounts, money would have to be found to continue paying benefits to current retirees. The long-term cost of privatization would likely be over \$2 trillion, with the exact amount depending on the nature of the privatized system. Since this cost has to be paid, taxes would have to be raised now or sometime in the future.

Proponents of privatization are counting on high stock returns to essentially “save the day.” But will the stock market come through? It is well known that stocks outperform bonds over a period of 20 to 30 years, but a stock market crash (such as the 1987 crash) on the eve of retirement can wipe out a substantial portion of a private individual account. Unless the worker can postpone retirement until the market recovers, retirement income will be considerably lower than anticipated and could quite possibly be less than that promised under the current Social Security system.

The key to successful retirement saving in a privatized Social Security system is prudent management of account assets. Experience suggests that many workers are not managing their 401K accounts prudently—some invest too conservatively, others invest recklessly—resulting in low retirement income. In addition, many lower-income workers have neither checking nor savings accounts and consequently have no experience managing assets in even basic financial institutions, such as banks or credit unions. A substantial minority of workers may simply not be prepared to effectively manage a Social Security individual account and make informed investment decisions. How far can and should the federal government go in helping people manage a privatized account?

Three policy changes could improve Social Security’s finances without across-the-board tax increases or annual benefit cuts. First, the Social Security payroll tax could be made less regressive by increasing the maximum taxable earnings level, which is \$87,000 for 2003. In 2002, both Jeffrey Immelt, the CEO of General Electric, and I paid the same

amount in Social Security taxes, yet Immelt, with annual compensation of almost \$7 million, earned over 70 times what I earned. Raising the maximum taxable earnings would affect less than 10 percent of the workforce and yet could dramatically improve the finances of Social Security.

Second, the early retirement age, currently at 62, could gradually be increased by two years. This would not cut annual benefits, but would reduce lifetime benefits, thus saving some money. In addition, this change would keep valued workers in the workforce longer. However, since not all older workers are physically able to remain on the job past age 62, the eligibility standards for disability insurance would have to be loosened for workers 62 years or older.

Finally, part of the trust fund could be invested in Government National Mortgage Association (also known as Ginnie Mae) mortgage-backed securities (MBSs), which typically have a higher yield than U.S. Treasury securities. This investment would not only increase trust fund assets, but would also help the mortgage market for low-income families. Back-of-the-envelope calculations suggest that \$500 billion could be added to the trust fund over the next 30 years. Ginnie Mae MBSs are less risky than stocks, although they are not completely riskless (prepayment risk is the main source of risk).

For the past 60 years, Social Security has been one of the government’s most successful programs for reducing poverty among the elderly. Social Security is not in dire financial straits and needs saving only from those who claim that privatization would save it. A few minor adjustments made now could strengthen the finances of Social Security, while a major overhaul of the system to include private accounts would jeopardize the financial security of the elderly for generations to come.

Conference

International Perspectives on Household Wealth

Scholars from eight countries met on October 17 and 18, 2003, at the Levy Institute to discuss the distribution of household wealth and saving in the United States, other advanced, industrialized economies, and one developing nation. Many of the presentations focused on recent trends in the portion of wealth held

by the richest people. Other topics included the role of religion in wealth accumulation and theories of wealth transfer taxation.

Session 1. Wealth Changes in the United States over the 1990s

This session was chaired by Levy Institute President Dimitri B. Papadimitriou. Arthur Kennickell of the Federal Reserve Board of Governors and John Czajka of Mathematica Policy Research, Inc., presented papers. The discussant was Timothy Smeeding of the Maxwell School, Syracuse University.

Kennickell began by presenting data on the “Forbes 400,” the wealthiest people in the United States, as estimated by the magazine of the same name. This group rapidly gained wealth during the 1990s but saw its net wealth fall from 2000 to 2002, probably reflecting the fluctuations of the financial markets. Kennickell also traced the Forbes 400 of 2001 back to 1989 and found that 170 were already on the list in that year.

Kennickell reported that in 2001, the usual rule of thumb—that the richest 1 percent, the next richest 9 percent, and the rest of Americans each hold roughly one third of net household wealth—once again held true. He also compared the wealth of various percentiles of the U.S. population. (As an example of what this means, the 90th-percentile household is richer than nine-tenths of the population and poorer than the rest.) At the lowest percentiles, net wealth fell from 1989 to 2001; as one considers higher percentiles, net wealth increased more and more steeply. The ownership of certain forms of wealth—such as stocks and bonds—is even more highly concentrated among the 99th percentile than net wealth as a whole.

Czajka described the findings of work he and coauthors Scott Cody and Daniel Kasprzyk had done for the Social Security Administration. The researchers found that different groups fared differently between 1993 and 1999. The wealth of older individuals grew more rapidly than that of the young. People under 30 were 20 percent poorer on average at the end of that period than at the beginning, while those over 75 held 50 percent more net wealth in 1999 than the same group did six years earlier. Among all racial and ethnic groups, non-Hispanic whites saw their average net worth grow fastest. Different income groups also fared differently. The wealth of the typical individual with an income of less than 200 percent of the poverty line declined significantly over the period studied by Czajka and his colleagues, while groups with somewhat higher incomes became richer. Social Security recipients under age 65 (mostly disabled people), a focus of the study, fared poorly by almost any measure. The mean net worth of these beneficiaries actually fell by 2 percent.

Smeeding stated that while certain findings in Kennickell’s paper were expected, there were some intriguing surprises. One such surprise was the mixed picture of how racial and ethnic minorities fared. More members of these groups held checking accounts or owned homes at the end of the period covered by the study than at the beginning, but at the same time more were indebted. Smeeding argued that the high levels of debt cited in both papers might not be undesirable if they were largely made up of student loans, since such loans often enable people of modest means to attend college.



John Czajka (*left*) and Arthur Kennickell



N. Anders Klevmarken (left) and Lars Osberg



Left to right: Asena Caner, Ajit Zacharias, and Edward N. Wolff

Session 2. Wealth Inequality in the Nordic Countries

Senior Scholar Edward N. Wolff of New York University chaired this session. N. Anders Klevmarken of Sweden's Uppsala University and Markus Jäntti of Abo Akademi University presented papers. Lars Osberg of Dalhousie University, Halifax, Nova Scotia, commented on both presentations.

Klevmarken presented a paper on wealth in Sweden during the 1990s. This period was distinctive in that the tax system was reformed and there was increasing uncertainty regarding the future solvency of the public pension system. Also, stock markets rose dramatically during the decade. At the heart of Klevmarken's presentation were statistical tests designed to find the main factors that determine net wealth. Klevmarken discovered strong relationships between net worth and other variables, especially education, immigrant status, place of residence, and home ownership. The data show that in recent years, Swedes have begun to purchase more financial assets, a finding Klevmarken attributes to widespread concern over the financial health of the public programs. The wealthiest 10 percent of Swedes fared well compared to other groups, although inequality in Sweden remained low by international standards. From 1987 to 1994, average net wealth fell somewhat. Later in the decade, average wealth increased, a trend that was probably driven by an increase in assets, rather than a reduction in debts.

Jäntti also attempted to disentangle the effects of various factors on the net worth and income of individuals and to find out how these effects have changed over time. He found that increasing income inequality among Finns could be attributed mostly to changes in the advantages of certain groups, such as

older people and men, rather than to changes in the numbers of people in each group. Put another way, even if the demographic makeup of the country had remained the same, inequality in incomes still would have increased significantly. The Finnish economist then turned to the correlation between income and wealth. His objective was to determine why high-income households also tend to have high wealth. He stated that even among households with similar income, wealth inequality increased from 1987 to 1998. Therefore, the increase in wealth inequality cannot simply be explained by increasing inequality in income.

Osberg made a number of comments that applied to both papers. An observation of importance, according to Osberg, was that exceptionally wealthy people may differ from others in their savings habits and motives. They may have more income than they can spend, whereas low- and moderate-income people may be unable to borrow money that they need even for essential expenses. Homes probably make up a large portion of the wealth of the latter group; tax laws regarding housing that differ from country to country may play an important role in enabling middle-class households to accumulate wealth.

Keynote Presentation: The Levy Institute Measure of Economic Well-Being

In the keynote address, Senior Scholar Edward N. Wolff and Research Scholars Ajit Zacharias and Asena Caner of the Levy Institute presented findings from their research on the Levy Institute Measure of Economic Well-Being (LIMEW). For a discussion of LIMEW, see page 12 in this *Report*.

Session 3. Wealth Trends in Europe

This session was chaired by Research Scholar Ajit Zacharias. Presenting papers were Andrea Brandolini of the Bank of Italy and Richard Hauser of Goethe University, Frankfurt am Main. The discussant was Jay Zagorsky of Ohio State University.

Brandolini said that in his country, tangible items, such as houses and cars, make up by far the greatest part of total assets, especially for the less well-off. Sixty to 70 percent of households own their own homes, a rate that compares favorably with most western European countries and has increased recently. Houses make up over one-third of the wealth of Italian households. Although many people purchased stocks and bonds during the 1990s, financial assets accounted for only 12 percent of total household net wealth in 2000. The Italian data show that the oldest Italians are not much worse off than those who are nearing retirement age (the difference between these age groups is much greater among North Americans). Those over 65 were relatively better off in 2000 than in 1989. In Italy, wealth is much less equally divided among the population than disposable income. As in a number of other industrialized nations, measures of net worth inequality rose in Italy from 1989 to 2000, and the total net wealth of all households has been on the increase. This contrasts with a stagnation of disposable income in recent years. Even though stock ownership has become more widespread since 1989, much of the increase in the gap between the rich and the poor can be explained by disparities in the ownership of stocks and other securities. Brandolini's paper was coauthored by Luigi Cannari, Giovanni D'Alessio, and Ivan Faiella of the Bank of Italy.

Hauser, presenting a paper he had written with Holger Stein of Goethe University, showed that inequality in West

Germany fell in the period immediately after 1973, then increased. An interesting contrast was drawn between Germany and many other nations. In most countries, including the United States, homeownership is relatively widespread, somewhat equalizing net wealth across different groups. Financial assets, such as stocks and bonds, are concentrated in a relatively small number of hands in these countries. The pattern is reversed in Germany: the distribution of wealth in the form of homes is more unequal than that of financial assets. Hauser used a measure of wealth based on assets that could actually be sold on markets. Like many other participants, Hauser presented graphs of the trajectories of "disposable wealth" over the life spans of several different generations that have already reached old age. These profiles show that the net wealth of Germans clearly peaks shortly before retirement, then falls until death. However, when the data were adjusted for household size, wealth peaked, on average, after age 65. Retirees tend to be relatively wealthy compared to the national average. The availability of recent data makes possible the comparison of inequality in the former East Germany with inequality in what was once known as West Germany. In 1993 and 1998 wealth was distributed in a more inequitable fashion in the East than in the West, though the gap narrowed in the latter year.

Zagorsky cited some of the key findings of both papers, drew some parallels between the two countries involved, and pointed out some remaining puzzles in need of further attention. The net wealth gap between northern and southern Italy has been widening, while Hauser's data reveal a convergence between East and West Germany. This contrast is worthy of further study, Zagorsky said. Another interesting and unexplained finding was the unusually high saving rate of Italian households.



Left to right: Jay Zagorsky, Andrea Brandolini, and Richard Hauser

Session 4. Wealth Trends in America

Levy Institute Professor Philip Arestis chaired this session. Two papers were presented: one by René Morissette of Statistics Canada and one by Seymour Spilerman, who had worked with Columbia University colleague Florencia Torche. Dalton Conley of New York University commented.

Morissette presented a paper he wrote with Xuelin Zhang and Marie Drolet, also of Statistics Canada, on the evolution of wealth inequality in Canada. The paper examined the extent to which wealth inequality is affected by changes in family structure, age, and relative wealth. Using data from the Assets and Debts Survey of 1984 and the Survey of Financial Security of 1999, he found that real average and median wealth rose approximately 10 percent, but wealth inequality increased over time. Median wealth fell in the poorest three-tenths of the wealth distribution and rose 27 percent or more in the top three-tenths. Inequality increased more among nonelderly couples with children and single-parent families. The authors also found that wealth inequality increased within many population subgroups. Factors that did not significantly affect the wealth gap included education, single-parent families, family size, province of residence, and urban/rural status. As measured by cross-sectional data, changes in lifetime expected income and sociodemographic characteristics explained, at most, 8 percent of the growing wealth gap.

Spilerman presented work on the effects of household net wealth on various economic “vulnerabilities” of Chileans. He and his coauthor anticipated that significant holdings of wealth would have the effect of enabling households to pay their regular monthly expenses during occasional times of

distress. Wealth would also play a role in reducing people’s worries about being unable to provide for retirement, pay unanticipated medical bills, or to handle any other unexpected setbacks. Spilerman and Torche focused their attention on the relative ability of those with little wealth, typical wealth, and high wealth at varying income levels to meet various challenges. They used recently released data from a survey of Chilean households. The authors found that household wealth, along with “social networks” and income, had a strong effect on the ability of households to pay their monthly expenses. Spilerman and Torche also found that for households with little wealth, income level had a strong effect on whether the household had enough resources to pay its monthly bills. Holding other factors constant, income had no impact on concerns about retirement, but social capital and financial wealth were key factors. Those who were enrolled in the private pension system (most Chilean workers) were no more likely to feel secure about retirement than those without pension coverage. In perceived ability to pay unexpected medical bills, both earnings and wealth played an important role.

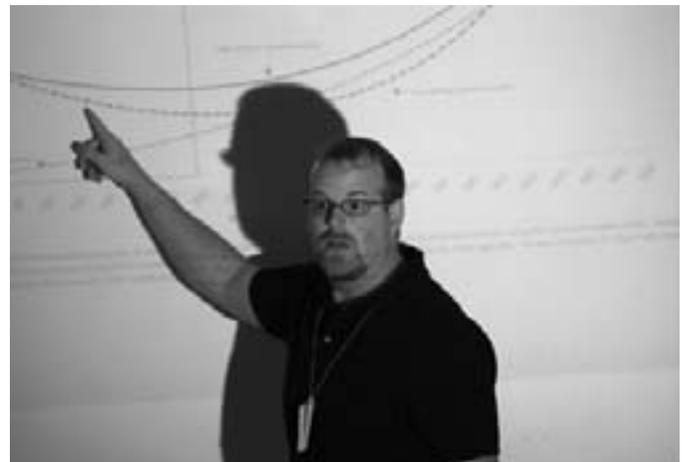
Conley commented on the possibility of reverse causation between two of Spilerman and Torche’s main variables: people may save more if they anticipate future vulnerability to job loss, etc. He proposed examining data on rich and poor households separately.

Session 5. Saving Behavior

Chair for the session was Wei-Jun Jean Yeung of New York University. Participants were Erik Hurst, University of Chicago;



Dalton Conley (left) and Seymour Spilerman



Erik Hurst



Ngina Chiteji

Ngina Chiteji, Skidmore College; and Maury Gittleman, Bureau of Labor Statistics.

A lack of access to loans is often cited as an obstacle to new business formation. In a study he coauthored with Annamaria Lusardi of Dartmouth College, Hurst found that there is no discernible relationship between household wealth and the probability of starting a business, except perhaps among the very wealthiest U.S. residents. The main reasons are that initial capital investments are small (the median was \$22,700 in 1987, and 25 percent of small businesses started with less than \$5,000) and many small businesses receive government loans. Recent changes in wealth, such as inheritances and housing capital gains, were unrelated to business entry. He also found that entrepreneurs were more likely to be white, male, married, highly educated, and have high incomes and wealth. For people with similar amounts of wealth, the probability of starting a business in a high-capital industry was similar to the probability in an industry with low capital requirements, with the exceptions of the wealthiest households and professional industries. This finding casts doubt on the claim that a lack of financial wherewithal is the main constraint on entrepreneurship. Hurst suggested that future research examine dimensions of the entrepreneurial process that could be affected by the inability to raise capital, such as starting businesses on a scale large enough to maximize profits, as well as the role of family background and the survival rate of businesses.

Kin networks frequently tie individuals together financially. In a paper coauthored with Darrick Hamilton of New School University, Chiteji examined the implications of family-based forces for wealth accumulation, wealth inequality, and public policy. Chiteji examined the patterns of financial asset

ownership across middle-class families and compared African American families with white families. African American families exhibited lower asset, bank account, and stock ownership rates, as well as lower incomes and wealth. Their relatives were more likely to receive aid (e.g., food stamps, public housing) or to be unemployed. Statistical methods were used to determine if there was an empirical connection between a family's wealth accumulation and the economic circumstances of kin. The wealth gap between African American and white households (\$35,733) could be accounted for in part by demographic variables, such as the household head's marital status and gender, and number of children; socioeconomic variables, such as schooling, occupation, and income; and family background, including wealth. But 57 percent of the gap remained unexplained. The inclusion of parental and sibling economic needs in the model reduced the unexplained portion of the gap to 45 percent. Relative to white families, African American families suffered a 27-percent reduction in their wealth as a result of kin networks.

Hurst and Lusardi made a very convincing case for the unimportance of constraints on borrowing, Gittleman said, including the weak connection between inheritances and business start-ups. Suggestions for follow-up research included the possibility that limits on borrowing could become binding after starting a business, and personal bankruptcy of less wealthy families could be the result of borrowing at higher interest rates. Gittleman noted the difficulty in devising a convincing empirical strategy to find out whether welfare reform policies affect the nonpoor. He suggested that the effect of changes in public policy, such as the Earned Income Tax Credit, may be a promising avenue of study.



Left to right: Robert A. Margo, Pierre Pestieau, Lisa A. Keister, and Thomas L. Hungerford

Session 6. Wealth Mobility and Public Policy

Chair for the session was Levy Institute Research Director and Senior Scholar Thomas L. Hungerford. Participants were Lisa A. Keister, Ohio State University; Pierre Pestieau, University of Liège, Belgium; and Robert A. Margo, Vanderbilt University.

Keister explored the relationship between religious affiliation and participation and early adult wealth accumulation in the United States. She surmised that religion affected wealth ownership directly (e.g., it shapes values and priorities, and provides important social contacts) and indirectly (it shapes processes that determine family wealth, such as fertility, divorce, education, and earnings). Using the National Longitudinal Survey of Youth administered by the Bureau of Labor Statistics, Keister focused on the group born in 1979 and tried to find the factors behind wealth ownership for the period from 1985 to 1998. She modeled the respondents' total net worth and financial assets as an adult, and the likelihood of respondents receiving an inheritance or owning a home. Religious affiliations in childhood and adulthood were identified as Jewish, conservative Protestant, mainline Protestant, or Roman Catholic. Keister separately accounted for various individual and family attributes that are related to wealth ownership, such as household income, inheritance, education, family size, family traits, and demographics. Keister identified three dominant patterns of asset ownership: the permanently asset-poor; an early transition to cash accounts and home ownership; and an early transition to financial wealth. Being raised Jewish and practicing Judaism as an adult were associated with tremendous gains in wealth. Conservative Protestants

were relatively wealth-poor, while affiliation with mainline Protestant and Catholic churches had no significant relationship with wealth ownership. Church attendance in childhood and adulthood was positively and significantly related to adult wealth. The findings affirmed the author's hypotheses about relationship patterns between religion and wealth: religion is an important element of culture, and family processes are important in shaping the way people accumulate assets.

Pestieau, in a paper coauthored with Helmuth Cremer of the University of Toulouse, France, focused on the criteria of equity and efficiency with respect to such wealth-transfer taxes as inheritance and estate taxes. He also noted that the implications of inheritance taxation depend on the reasons that people leave assets when they die. To understand the importance of gifts and estate transfers, the authors examined various bequest motives—altruistic, paternalistic, strategic, and accidental—using an economic model in which people were assumed to live through young adulthood and retirement, then leave money to their children. The model included three types of taxes: a proportional tax on earnings, interest income, and inherited wealth. The authors introduced various wealth transfers into the model and determined the form of wealth taxation best suited to each motive. The authors distinguished among three categories of taxes: estate, inheritance, and accession. Estate taxes apply to the total amount left by the deceased person; inheritance taxes, which are more common than estate taxes in Europe, are based separately on the amount given to each heir. The authors found that the optimal tax structure and the effect of various taxes on economic efficiency depended on the bequest motive. The study showed that the most efficient tax regime is different from existing tax regimes: it resembles the inheritance tax, but without compulsory equal sharing.

Margo noted that Keister's "effects of religion" observations were correlations and should not be equated with causation. The discussant further noted that many important influences on wealth were left out of Keister's equations. The paper's insights should be applied to other eras and countries, particularly changes over time. Margo suggested that the theory in Pestieau's paper should be supplemented with more empirical data, such as history of estate taxation and the economic effects of wealth taxation. How do variations in estate taxes affect such things as capital accumulation, fertility decisions, or inter vivos transfers?

Session 7. Wealth among the Low-Income Population

The chair for the session was Mark Wilhelm of Indiana University–Purdue University Indianapolis. Participants were Frank P. Stafford and Elena Gouskova, University of Michigan; Asena Caner, Research Scholar, the Levy Institute; Edward N. Wolff, Senior Scholar, the Levy Institute, and New York University; and Howard Iams, Social Security Administration.

In a paper coauthored with F. Thomas Juster of the University of Michigan, Stafford (via audio feed) and Gouskova examined three aspects of household portfolios—diversification, composition, and management—that shape portfolio allocation decisions. Using data from the Panel Study of Income Dynamics (PSID), a study that followed a group of individuals over time, the authors examined ownership rates of the main components of household wealth, assessed the factors shaping choices among the top portfolio combinations in successive time periods, and considered the timing of asset-holding decisions. They found that family net worth had increased by approximately 50 percent during the period they studied, 1984 to 2001. Average wealth remained low among African American households and the gap between African Americans and whites remained large. The authors examined seven types of portfolios and found that portfolio choice was strongly associated with income, race, and education. Education and marital status had significant positive effects on portfolio diversification, and African American households averaged one fewer asset in their portfolios than whites. The most distinctive shift in the distribution of portfolio types was toward a greater share of housing equity, as well as stocks and IRAs (from 25 percent of households in 1984 to 40 percent in 2001). The authors reviewed transaction activity in separate

time periods by considering patterns of shifts in portfolio size, in the frequency of household portfolio change, and in the most popular portfolio combinations.

Caner and Wolff proposed a poverty measure and estimated the amount and severity of asset poverty in the United States for various demographic and labor market groups using PSID data for the period 1984–1999. Asset poverty was defined by the condition of a household whose access to wealth-type resources is insufficient to meet its basic needs for three months. Caner and Wolff used three alternative wealth measures—net worth, net worth minus home equity, and liquid wealth, which included readily disposable assets, such as bank accounts. On average, asset poverty was two to four times as prevalent as income poverty. According to the net worth measure, a significant portion of the U.S. population in 1999—26 percent of all households—was in asset poverty. About half of U.S. households had less than \$5,000 in liquid assets. Asset-poverty rates showed striking differences among racial/ethnic groups. Single female-headed families with children had the highest rate of asset poverty. There was no evidence that the gap between African Americans and whites had narrowed over the study period, or that overall poverty had fallen. An innovation of the study was its investigation of the correlation between asset-poverty transitions with major lifetime events (e.g., divorce, illness, inheritance, starting a new business).

Iams, as discussant, suggested the inclusion of Social Security benefits, defined benefit pensions, and defined contribution pensions in the concept of assets and wealth. He also recommended that the papers compare the same birth cohort at two points in time rather than comparing people of a given age in different years. Iams agreed that longitudinal studies using the PSID database are useful, but cautioned that the PSID included information that was estimated rather than directly measured. Also, the data can be misleading because so many individuals stop answering survey questions before the end of the survey.



Left to right: Elena Gouskova, Mark Wilhelm, and Dimitri B. Papadimitriou

New Publication

The Levy Institute Measure of Economic Well-Being: United States, 1989 and 2000.

EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER

www.levy.org/pubs/limew/limew1203.pdf

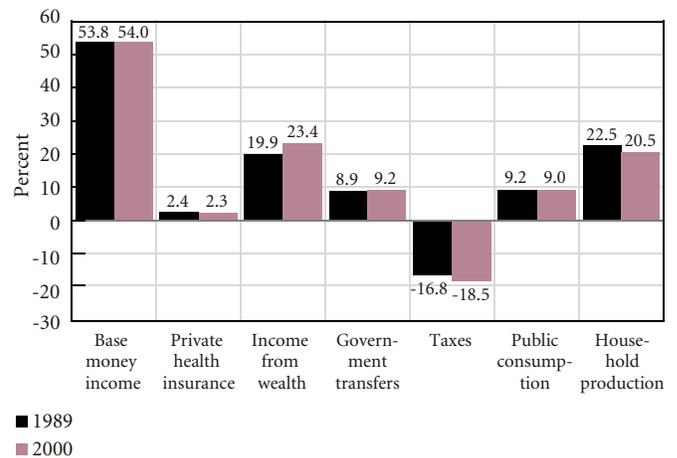
It has long been recognized that the Census Bureau's measure of household income and its distribution are imperfect measures of economic well-being. Senior Scholar Edward N. Wolff of New York University and Levy Institute Research Scholars Ajit Zacharias, and Asena Caner have been working on an alternative measure that includes items neglected by government statistics.

The new measure, known as the Levy Institute Measure of Economic Well-Being (LIMEW), is also an income measure (i.e., its components are all measured in dollars), but is more inclusive. It is intended to measure the command or access by members of a household over the goods and services produced during a given period of time. Some of the new items included in the measure are the value of government services that directly benefit households; the effects of taxation; production within households, including housework; and the benefits of wealth holdings, such as stocks and homes.

Using a detailed empirical methodology, Wolff, Zacharias, and Caner have developed new measures of the level and distribution of household income. The authors find that standard income data, which seek to measure the command over commodities, understate the level of inequality in the distribution of such command and underestimate the average household's access to goods and services. The group calculated well-being at two points in time: 1989 and 2000. During that period, median LIMEW (the LIMEW of the household in the middle of the distribution) grew by 11 percent, while standard income measures increased by only 5 percent.

As with standard indexes of well-being, LIMEW was less evenly divided among households in 2000 than in 1989. The wealth portion of LIMEW contributed to the increase in inequality, possibly indicating that households at the top of the wealth ladder disproportionately benefited from the run-up in the stock market that took place during the period. Both taxes and government services have the effect of making inequality lower than it would otherwise be, but this effect was weaker in 2000 than in

Figure 1 Composition of the LIMEW, 1989 and 2000



Source: Authors' calculations

1989. The inclusion of household production also partly levels the distribution of well-being among households. Work within the home was not equally divided among household members, though; men performed 35 percent less than women. Total work (household plus paid) increased from 1989 to 2000.

In recent publications, Wolff, Zacharias, and Caner describe their methods for estimating the benefits to households of government programs and wealth. They use a variety of data to adjust Census income measures. For example, they use survey data from the Federal Reserve Board to estimate the assets held by different groups of households. These resources include homes, financial assets like stocks and bonds, and retirement assets. The scholars convert the dollar values of all of these assets into an equivalent annual stream of income so that they can be added on to the usual measures of well-being.

The authors estimate the benefits of government services based on expenditures in various categories, such as transportation, and the percentage of each category actually used by the household sector. For example, most education spending is assumed to directly benefit individual households, while defense expenditures constitute a "social overhead."

Wolff, Zacharias, and Caner found that citizens with high incomes tend to enjoy larger amounts of "public consumption," their term for the amount of government spending benefiting each household. However, the value of public consumption is a greater percentage of the total income of lower-income groups, according to data for 2000. Average household public consumption was about \$8,200.

When the authors adjust income to include the benefits of asset ownership, the distribution becomes less equal. For example, households whose incomes fall in the top one-tenth of the population receive 32 percent of money income, but that figure rises to 41 percent when wealth income is added.

The authors draw several conclusions regarding public policy. Efforts to alleviate inequality should address disparities in net wealth, not just income, since the former contributes greatly to overall inequality. Recent cuts in social programs and taxes have had the effect of exacerbating inequality and should be reversed or modified. Finally, the government should encourage workplace arrangements that help ease pressures on households to increase their total hours of work.

New Strategic Analysis

Deficits, Debts, and Growth: A Reprieve But Not a Pardon

ANWAR M. SHAIKH, DIMITRI B. PAPADIMITRIOU,
CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA
www.levy.org/pubs/sa/stratan-oct-03.pdf

One of the biggest economic stories of the past two years has been the swing from government surpluses to large deficits. In the latest strategic analysis, the Levy Institute examines how recent changes in fiscal policy affect the economy's other main balances and economic growth.

The Institute has been predicting for some time that it would be necessary to increase the federal deficit in order to pull the country out of recession and improve the private sector balance. The private sector can no longer be the engine of growth, primarily because it is saddled with a huge debt burden and because the real estate market may be on the verge of collapse. Exactly what scenarios might one expect, given assumptions about future deficits and growth rates?

The authors of the new analysis are Senior Scholar Anwar M. Shaikh of New School University, Levy Institute President Dimitri B. Papadimitriou, Research Scholar Claudio H. Dos Santos, and Gennaro Zezza, a Levy Institute research scholar affiliated with the University of Cassino, Italy. The first scenario they consider is that of the Congressional Budget Office (CBO),

a nonpartisan agency. This organization has predicted large but decreasing budget deficits for the next three fiscal years. Using the CBO deficit projections, along with its predictions about growth, the authors simulate the future course of the economy in what they call "scenario one." The main problem that arises is that the current account deficit would remain at about 5 percent of GDP.

Citing the excessive optimism of the CBO projections, the authors then consider "scenario two," in which government deficits are even higher and the private sector retrenchment is larger. The CBO's deficit projections will probably prove to be too low because they were calculated under the assumption that the recent tax cuts will be allowed to expire. Scenario two assumes that the cuts will be renewed and takes into account the \$87 billion in spending on Iraq recently authorized by Congress.

The authors' computer simulation of scenario two shows that growth would be higher than in scenario one. However, the current account deficit would become even more unmanageable than in that baseline scenario, and government deficits would average 7 percent of GDP during the time period covered by the simulation. Does any alternative exist to the unsustainable paths implied by the first two scenarios?

Currency devaluations are one way of reducing current account deficits. They raise the prices of imported goods and make exports more competitive. The authors therefore include a 20 percent devaluation of the dollar among their assumptions in "scenario three." But the results are not encouraging. While growth improves significantly over the second scenario, improving the financial situation of the private sector, the current account deficit falls by only a small amount. Apparently, a dollar devaluation does not represent a complete solution to the international imbalances that threaten the stability of the world economy.

New Policy Notes

Pushing Germany Off the Cliff Edge

JÖRG BIBOW

Note 2003/4

www.levy.org/pubs/pn/pn03_4.pdf

In a new policy note, Research Associate Jörg Bibow offers his perspective on recent macroeconomic problems and policies in Germany and the Eurozone. He argues against the claim that Germany's fiscal problems can be traced to the costs of unification. In Bibow's view, the German government overreacted to the deficits that immediately followed unification. In its concern about the possible inflationary consequences of fiscal imbalances, the German government increased taxes on goods and social insurance contributions, a move that contributed to inflation, rather than dampening it. Fiscal problems lingered, but they can be attributed to a policy-induced recession that began in 1992. The German government lacked the tools to fight the recession because its central bank was strongly committed to fighting nonexistent inflationary pressures.

Bibow cites a number of problems with Germany's favored macroeconomic strategy, structural reforms. There is some truth to the notion that taxes increase costs by inserting a wedge between what workers receive for an hour's work and what employers have to pay for the same hour. The German government has tried to reduce the size of this wedge by cutting unemployment benefits and other social programs. This move only compounds the country's economic problems by taking money out of consumers' pockets. A better approach to low growth rates would be to adopt more expansionary policies of the type that have proven successful in the United States. This might help alleviate Germany's and America's persistent current account imbalances, which the European Central Bank blames on forces beyond its control.

Deflation Worries

L. RANDALL WRAY

Policy Note 2003/5

www.levy.org/pubs/pn/pn03_5.pdf

In a new policy note, Senior Scholar L. Randall Wray of the University of Missouri-Kansas City argues that policymakers around the world are failing to take appropriate steps to ward off deflation. As of now, the signals of potential deflation are mixed, but prices have fallen recently in a number of countries around the world. The weak GDP growth that usually accompanies deflation has been present for years.

The Federal Reserve Board has acknowledged the possibility of deflation for some time. However, Wray doubts the Fed's power to prevent deflation. Fiscal policy holds more potential to lift the economy out of a deflationary spiral. But the reemergence of deficits is largely the result of a reduction in tax revenues due to low growth; the administration's stimulus plans have actually been relatively small and cannot be counted on to restore growth or prevent deflation. Certain components of these plans, such as the reduction in dividend taxes, may do little to put money into the hands of those who will spend it. The lack of strongly expansionary tax and spending policy is partly to blame for the onset of recession three years ago.

The litany of factors working against stimulus is long: a potential fall in the property markets, a large burden of private-sector debt, a lack of investment, and persistent unemployment, to name a few. A collapse of the real estate markets is a particularly perilous possibility and would likely have more of an impact on the economy than the recent bear market for stocks. Given these drags on growth, a federal deficit of approximately 7 percent of GDP would probably be appropriate. It is best to act early; as the Japanese experience shows, once deflation has set in the policy challenge becomes greater.

Is International Growth the Way Out of U.S. Current Account Deficits? A Note of Caution

ANWAR M. SHAIKH, GENNARO ZEZZA, and
CLAUDIO H. DOS SANTOS
Policy Note 2003/6
www.levy.org/pubs/pn/pn03_6.pdf

The U.S. current account deficit has been a major concern of the Levy Institute for some time. In the Strategic Analysis series, we have pointed out that the nation's current account deficit, which is now about 5 percent of GDP, is unsustainable and acts as a drain on aggregate demand. A new policy note by Senior Scholar Anwar M. Shaikh, Research Scholar Gennaro Zezza of the University of Cassino, Italy, and Research Scholar Claudio H. Dos Santos describes a new data set created by the authors in an effort to better understand current account balances.

The authors are interested in ascertaining the causes of imbalance. Some economists trace the problem to weak import demand from other nations. For example, many economies in Europe have been growing slowly or not at all and therefore are weak markets for U.S. goods and services. In order to test the validity of this theory, Shaikh, Zezza, and Dos Santos calculated the total GDP of U.S. trading partners. If this figure declined as the current account deficit widened, then the data would support the theory.

The authors' measure of trading-partner GDP actually fell relative to U.S. GDP during most of the last decade. Taking the next logical step, the authors divided the trading partners into two groups: the mainly European and North American "major-currency trading partners" and the "other important trading partners," a group that includes many emerging markets. It turns out that while the former group's GDP shrank relative to U.S. output, the latter set grew faster. Since the "other important" trading partners account for most of the U.S. deficit, this finding seems to be at odds with the notion that relative growth rates account for the gap.

While increased world growth rates would be desirable for many reasons, the note shows that they are probably not a complete solution to current account imbalances. The authors also call into question the effectiveness of a possible devaluation of the dollar in correcting the imbalances. There is, unfortunately, no tool readily at hand that can be used to eliminate current account deficits.

The Future of the Dollar: Has the Unthinkable Become Thinkable?

KORKUT A. ERTÜRK
Policy Note 2003/7
www.levy.org/pubs/pn/pn03_7.pdf

When an economy runs a large current account deficit, international demand for its currency falls. The lack of demand for a currency follows from the reduced need of firms and consumers around the world for money to purchase goods and services produced by the deficit nation. Theoretically, the probable outcome is a fall in the value of the currency in question against other world currencies.

Recently, the United States has appeared to be a likely candidate for a devaluation. Its current account deficit equals approximately 5 percent of GDP. Still, the dollar's value has fallen by only about 5 percent against its trading partners. The primary reason for this buoyancy may be that foreign central banks, especially in Japan and China, are purchasing dollars in an effort to suppress the value of their own currencies.

Not only does this precarious position present a risk of devaluation, but it could lead to a complete loss of the dollar's status as one of the world's main reserve currencies. Research Associate Korkut A. Ertürk of the University of Utah argues in a new policy note that any fall in the dollar's value may be nipped in the bud, due to concern about the negative effects of a devaluation. A devaluation would be unwelcome for much of the world if it drastically curtailed U.S. demand for foreign goods, thus ending the U.S. role as the customer of last resort. Also, a devaluation often brings with it higher interest rates, which might offset many of its other benefits. Ertürk argues that while various factors may discourage a gradual retreat of the dollar's value, a risk remains that the dollar will collapse suddenly and dramatically.

The dangers of a fall in the dollar are not confined to the U.S. economy. In Japan, fears of a decline act as a drag on stock market values because investors fear that the country's export industries could suffer. At the same time, the prospects of a devaluation make U.S. securities unattractive because they are denominated in dollars. Thus, the default asset for many Japanese investors has been cash, leading to the so-called "liquidity trap" that has rendered monetary policy ineffective. Unfortunately, all of the concerns about devaluation may be justified. Scenarios involving an easy or painless solution to the overvaluation of the dollar seem excessively rosy.

New Working Papers

Financial Sector Reforms in Developing Countries with Special Reference to Egypt

PHILIP ARESTIS

Working Paper No. 383

www.levy.org/pubs/wp/383.pdf

In a new working paper, Institute Professor Philip Arestis shows that financial and banking crises in many developing countries are the result of hastily carried out and ill-conceived liberalization programs. He offers the case of Egypt as an example of how these problems can be averted by adopting a slow, cautious approach to financial reform.

What reforms have been undertaken in developing countries, and what kinds of crises have ensued? “Financial liberalization” usually includes the opening of borders to borrowing and lending. It is often accompanied by government deficit reductions and tight monetary policy. When such reforms are implemented, they sometimes attract inflows of foreign capital, but the money from abroad is often used to speculate on financial assets rather than for long-term projects, such as new factories. The result is a boom in stock markets, property markets, or some other sector. Eventually, asset prices in these markets return to earth, and the foreign lenders and investors withdraw their money. Domestic borrowers then must pay higher interest rates to roll over their loans. If they are unable to do so, they sometimes default. Paying off all the bad debt created during recent crises in Asia, Latin America, and elsewhere has cost at least 10 percent and as much as 55 percent of annual GDP in the affected countries.

Since liberalization efforts have led to these problems in so many nations, the case of Egypt, which has avoided crisis, is interesting and may serve as a model for other developing nations. Arestis believes that the cautious pace of reform in Egypt is what accounts for its success in preventing currency, debt, and banking crises. The state-owned banks still dominate the industry in Egypt. Nevertheless, foreign exchange controls have been lifted, some interest rate caps have been abolished, and trade restrictions have been loosened. The slow introduction of these measures has given the domestic banking and financial system time to reduce costs, eliminate nonperforming loans, and increase capital ratios. The institutional groundwork

has thus been laid for liberalization. Also, many forms of what liberalization advocates pejoratively call “financial repression” have been kept in place. Perhaps, as the advocates say, efficiency has been sacrificed, but the stability of financial systems has been enhanced.

Minsky’s Acceleration Channel and the Role of Money

GREG HANNSGEN

Working Paper No. 384

www.levy.org/pubs/wp/384.pdf

Many observers credited the easy policies of the Federal Reserve Bank and its chairman, Alan Greenspan, with the boom of the 1990s. Low interest rates encouraged capital spending by industry and a wave of mortgage-financed purchases. But the same sort of stimulative monetary policy appears to have had only a minimal effect in fighting the last recession, at least until recently. In a new working paper, Resident Research Associate Greg Hannsgen uses theory and empirical evidence to assess the effectiveness of monetary policy.

Hannsgen’s theory, which is based upon a hypothesis developed by the late Levy Institute economist Hyman Minsky, posits that spending falls in time of increasing interest rates to a greater extent than it is reduced when interest rates are high but stable. Hannsgen accounts for the economic impact of changing interest rates by citing their impact on businesses and households with short-term debts that they must periodically “roll over” or refinance. Often, the profits of banks or other firms are fixed contractually. When interest rates rise, such companies are squeezed between higher outflows of cash and constant inflows. They often declare bankruptcy or at least curtail their purchases of new capital goods. An example is the savings and loan crisis of the 1980s, during which thrift institutions were forced to pay higher interest rates because of the inflation and tight monetary policy of that time. Savings and loans’ portfolios were largely made up of fixed-rate mortgages. The resulting combination of high interest costs and relatively low investment income was one of the main causes of the crisis.

Hannsgen presents a model of Federal Reserve policy-setting, investment demand, and inflation that incorporates Minsky’s idea. He shows that, according to his model, the acceleration of interest rates that occurs when central banks

tighten policy can destabilize the economy. Such instability is a hallmark of Minsky's theory. Hannsgen uses an econometric technique to gauge the effect of interest rate changes in the United States since the 1950s and finds that they have had a major impact on the total output of the economy. He thus demonstrates that interest rate manipulation can have an effect on the economy, especially during periods when rates are rapidly changing. The effect of monetary policy may operate through a different mechanism than that of textbook economic theory. Money does matter, so monetary policy can be a force for good or evil.

Macroeconomic Policies of the Economic and Monetary Union: Theoretical Underpinnings and Challenges

PHILIP ARESTIS and MALCOLM SAWYER
Working Paper No. 385
www.levy.org/pubs/wp/385.pdf

In a new working paper, Institute Professor Philip Arestis and Senior Scholar Malcolm Sawyer of Leeds University provide a detailed alternative to the current policies of the European Monetary Union. The authors first sketch the main elements of the current situation: tight limits on budget deficits, which have proven impracticable, and restrictive monetary policies set by the European Central Bank (ECB). They trace the intellectual lineage of this set of policies to the "new consensus" among many economists about macroeconomic policy. The consensus belief is that economic output tends to gravitate spontaneously to a certain level at which inflation is constant. This level of output can be increased by reforms, such as the reduction of labor market regulations, and not by budget deficits or interest rate reductions.

Because the current institutions and policies of the eurozone have proven ineffective, Arestis and Sawyer suggest some major changes. The ECB has attempted to control inflation by maintaining relatively high interest rates. Still, inflation is above its target level. Moreover, Arestis and Sawyer lay much of the blame for the high unemployment rates in many of the eurozone's nations on the ECB's "tight" monetary policy.

A better way of controlling inflation would be to set up some form of centralized wage bargaining, in which a noninflationary level of compensation could be agreed upon. This

type of "incomes policy" has been used successfully in the past in many European countries.

Another innovation proposed by Arestis and Sawyer is a public investment bank for the eurozone that would provide capital to its less prosperous areas. Such a bank would fill a need to correct disparities among regions in industrialization and income levels. It would also provide additional production capacity, creating an outlet for increases in the demand for goods and services. At present there is insufficient unused plant and equipment to accommodate all unemployed workers, even if companies were willing to hire them.

To give the eurozone more tools to stimulate the economy, Arestis and Sawyer propose a centralized budget of about 5 percent of the region's GDP. In times like the present, when unemployment is high for the region as a whole, the eurozone could spend borrowed money. The authorities would then be able to coordinate their budgetary and monetary policies. Also, individual national governments should be freed from existing budget deficit limits, and the ECB should be given a mandate to maintain a high level of employment, as well as a low level of inflation.

Household Wealth, Public Consumption, and Economic Well-Being in the United States

EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENSA CANER
Working Paper No. 386
www.levy.org/pubs/wp/386.pdf

Working Paper No. 386 and its subject, the new Levy Institute Measure of Economic Well-Being (LIMEW), are discussed in detail on page 12 of this *Report*.

Measures of the Real GDP of U.S. Trading Partners: Methodology and Results

CLAUDIO H. DOS SANTOS, ANWAR M. SHAIKH, and GENNARO ZEZZA
Working Paper No. 387
www.levy.org/pubs/wp/387.pdf

This working paper is a more technical version of Policy Note 2003/6, which is described in this issue of the *Report* on page 15.

Inflation Targeting: A Critical Appraisal

PHILIP ARESTIS and MALCOLM SAWYER

Working Paper No. 388

www.levy.org/pubs/wp/388.pdf

Inflation targeting is a form of interest rate policy that has won many advocates in recent years. Central banks in many countries, including Great Britain, are said to have adopted inflation targeting to some extent. In a new working paper, Institute Professor Philip Arestis and Senior Scholar Malcolm Sawyer of the University of Leeds challenge the acceptance of this practice.

To target a particular rate of inflation, a central bank simply raises (lowers) interest rates if inflation exceeds (falls below) the target. In practice, central banks using inflation targets often take into consideration other variables, such as unemployment, in choosing an appropriate interest rate.

The advocates of this approach to monetary policy claim that it has been successful. However, there are numerous theoretical and empirical shortcomings to the case for inflation targeting, which often rests on the tenets of the “new consensus” in macroeconomic theory. Adherents of the new consensus often underestimate the importance of maintaining sufficient demand for the economy’s output. They overlook the potential stabilizing effect of budgetary policy. They emphasize inflation control over all other policy goals, neglecting the importance of steady and rapid economic growth.

Not surprisingly, some studies of inflation targeting have come to the conclusion that the reduction of inflation to very low levels often reduces the rate of economic growth. Moreover, while inflation-targeting countries have succeeded for the most part in taming inflation, so have most countries with different monetary policy regimes. Also, there is little reason to believe that inflation targeting can effectively deal with price increases that result from “supply shocks,” such as oil price increases.

The dubious effectiveness of monetary policy is demonstrated by numerous statistical studies, which indicate that moderate interest rate increases have only a small inflation-reducing effect. Many empirical studies have also found that interest rate policy exerts its effects largely through its influence on purchases of capital goods, such as new factories. Such purchases have the effect of boosting productivity (output per worker), so an antiinflationary drive, if carried too far, can permanently reduce GDP. All in all, the facts do not warrant the adoption of this extreme measure.

Do Workers with Low Lifetime Earnings Really Have Low Earnings Every Year? Implications for Social Security Reform

THOMAS L. HUNGERFORD

Working Paper No. 389

<http://www.levy.org/pubs/wp/389.pdf>

A new working paper by Research Director and Senior Scholar Thomas L. Hungerford asks the question posed in the title above. The answer is important, because different types of retirement programs have different effects on those who do not have significant earnings in every year of their working-age lives. Some economists and politicians have proposed that traditional Social Security benefits be partly replaced by individual retirement accounts. Because of the effects of compound interest, such accounts especially reward contributions that are made at an early age. Workers who do not set aside money every year—for example, those who leave the workforce temporarily to raise children—may find themselves at a disadvantage in providing for their old age.

Many experts do not take into account nonworking years in their calculations of how low-income workers will fare under various proposed changes to the retirement system. For example, the Social Security Administration’s Office of the Actuary estimates how various proposed changes in the Social Security program would affect a worker who earned 45 percent of the economywide annual wage every year for 40 years. If many low-income workers do not work every year, such an estimate will provide a misleading picture of their retirement income, perhaps leading policymakers to adopt a policy that is an unfavorable deal for the poor. It may be preferable to keep Social Security intact, because current law allows spouses of retirees to receive Social Security benefits of their own, regardless of their work history. However, the existing Social Security program provides poor coverage for spouses who leave the workforce for some time but are not married to a retiree for at least 10 years.

Using data from several nationwide surveys, Hungerford confirms that women are more likely than men to have low total lifetime earnings and to have missed some years of work. Twenty-six percent of men with low lifetime income worked less than 25 years from ages 22 to 61, compared with 44 percent of women in the same age group. Women baby boomers, who are now nearing their retirement years, are more likely to

have worked throughout their adult lives than the subjects of this study, and are therefore less likely to have low lifetime earnings. Still, the author calculates that almost half of women baby boomers will fall into the two lowest lifetime earnings groups, partly owing to periods of zero earnings. Future reforms of the retirement system will shortchange women if they do not include protections for those who did not work throughout their careers.

Savings of Entrepreneurs

ASENA CANER

Working Paper No. 390

www.levy.org/pubs/wp/390.pdf

Not surprisingly, numerous studies have documented that business owners are, on average, much wealthier than the general population. In a new working paper, Research Scholar Asena Caner examines how they become relatively rich. Do capital gains on their businesses account for the wealth of entrepreneurs? Do they simply save more of their incomes? Or do those who start businesses tend to be wealthy even before they make their first sale? If high net worth enables one to start a business more easily, why can't less wealthy households borrow the entrepreneurial capital they need?

Caner uses data from the Panel Study of Income Dynamics, a survey that followed the same households over a long period of time. She divided her sample into four groups: those who did not own a business at any time between 1984 and 1989, those who started a business during that time frame, those who went out of business in that period, and those who never owned a business. The wealth of business starters grew more rapidly than that of any of the other three groups. Those who started with a business and were no longer in business at the end of the period actually had less wealth in 1989 than in 1984. Even excluding money that they invested in their businesses, entrepreneurs were much richer in 1989 than in 1984.

How did entrepreneurs manage to amass more wealth than the other groups? Caner was able to go beyond earlier studies by breaking down changes in entrepreneurs' wealth into capital gains, inheritances, and saving out of income. Those who started a new business tended to put aside more savings out of their incomes than others and to enjoy larger

capital gains on their assets. Also, those who owned businesses throughout the period studied saved more than those who never had a business of their own.

Caner also tested the data to be sure that entrepreneurs' high rate of savings accumulation was not due to other differences that might exist between entrepreneurs and nonentrepreneurs, such as age, marital status, or income. She found that even after taking into account such differences, entrepreneurs saved more than nonentrepreneurs. She also found that their overall wealth did not expand more rapidly. Thus, she concluded that an entrepreneur was no more likely to accumulate large amounts of wealth than a nonentrepreneur who was identical in other respects.

Aggregate Demand, Conflict, and Capacity in the Inflationary Process

PHILIP ARESTIS and MALCOLM SAWYER

Working Paper No. 391

www.levy.org/pubs/wp/391.pdf

In a new working paper, Institute Professor Philip Arestis and Senior Scholar Malcolm Sawyer of the University of Leeds present a comprehensive alternative to standard explanations of output and inflation changes.

Of particular interest to Arestis and Sawyer is the question of whether automatic mechanisms exist to ensure that the economy adjusts to full employment. Also, the authors examine the closely related view that the amount of economic output cannot be permanently increased through expansionary macroeconomic policies.

The authors first present a model of the economy that encompasses price- and wage-setting, the distribution of output, and employment. Some noteworthy features of their model are that investment depends upon the extent to which existing plant and equipment are being used; the rate of inflation is partly determined by conflicts between workers and firms over their shares of output; and the quantity of money in existence is determined by the needs of firms and consumers, rather than central bank policy.

In the model developed by Arestis and Sawyer in this paper, the level of spending, partly determined by government policy, affects the economy in two ways. First, unless the economy is beyond its "inflationary barrier," output is increased.

Second, spending on capital goods increases the productive capacity of industry, an effect that tends to move the inflationary barrier outward, allowing the achievement of a higher standard of living.

The authors use a wide range of sources of empirical information to test how their theory holds up in the real world. First, they review studies that draw upon data from a number of advanced economies. They find only very weak evidence for the alternative theory that labor market laws, conceived broadly to include the tax and welfare systems, are the main determinants of unemployment. Consistent with their own theory, they find that the demand for goods and services has a strong influence on output, even over long periods of time. The accumulation of capital stock, which accelerates when output is high, appears to be an important variable through which output demand exerts its effects.

Arestis and Sawyer also point to strong empirical evidence that investment decisions are in large part driven by the availability of retained earnings and by the degree to which productive capacity is being used. They argue that vastly differing unemployment rates across regions of countries are not consistent with the claim that labor market taxation and regulation are the key factors behind the minimum sustainable rate of unemployment.

Understanding Deflation: Treating the Disease, Not the Symptoms

L. RANDALL WRAY and DIMITRI B. PAPADIMITRIOU
Working Paper No. 392
www.levy.org/pubs/wp/392.pdf

In a new working paper, Senior Scholar L. Randall Wray of the University of Missouri–Kansas City and Levy Institute President Dimitri B. Papadimitriou argue that many observers have misunderstood the nature of the threat posed by deflation; hence, their proposed countermeasures fail to address its main causes.

Wray and Papadimitriou believe that falling prices are not always a pernicious problem. For example, improvements in efficiency can enable firms to reduce their prices without sacrificing profits. What is more dangerous than a fall in the prices of consumer goods is a collapse of markets for assets such as real estate and securities. The most dangerous type of deflation, last seen in the Great Depression, involves goods,

labor, and asset markets. If wages and the prices of output fall, debtors are likely to default on debt commitments that are fixed in nominal (dollar) terms. Defaults, in turn, tend to lead to collapses in the values of bonds and to bank failures. Often, when firms and consumers are short of cash to pay off debts, they sell large amounts of financial assets, which can lend further momentum to asset market debacles. The late Levy Institute economist Hyman Minsky warned that this sort of deflation could happen again.

Minsky argued that the problem of deflation was, at its roots, a problem of insufficient demand for goods and services. In the postwar era, the government has prevented Minskian deflation through deficit spending and direct support to ailing financial institutions. One example is the Federal Reserve's aggressive response to the stock market crash of 1987.

Fed officials and economists have proposed very different remedies in the event of a modern deflation. Ignoring the failure of monetarist policies to control the money supply during the 1970s, these commentators have proposed deliberate efforts to expand the amount of dollars in circulation. A major problem with this approach is that it is intended to deal primarily with prices themselves, rather than the underlying problem of deficient demand.

The authors note that despite the recovery of the last two years or so, many forces exist that make deflation possible. Wray and Papadimitriou believe that these deflationary pressures should be countered with a fiscal stimulus package that includes rebates of social security payroll taxes, as well as support for the states and projects to improve the nation's physical infrastructure. Such a fiscal shift would enable households to pay off some of their debts without drastically reducing their expenditures. A broad-based stimulus package would fight the source of deflationary pressures—inadequate demand for products and labor—instead of ineffectually focusing on prices themselves.

Working papers 393 to 396 were presented at the International Perspectives on Household Wealth conference at the Levy Institute. Please see the summaries of these papers in our report on the conference, beginning on page 4.

A Rolling Tide: Changes in the Distribution of Wealth in the U.S., 1989–2001

ARTHUR B. KENNICKELL

Working Paper No. 393

www.levy.org/pubs/wp/393.pdf

Wealth Transfer Taxation: A Survey

HELMUTH CREMER and PIERRE PESTIEAU

Working Paper No. 394

www.levy.org/pubs/wp/394.pdf

On Household Wealth Trends in Sweden over the 1990s

N. ANDERS KLEVMARKEN

Working Paper No. 395

www.levy.org/pubs/wp/395.pdf

The Evolution of Wealth Inequality in Canada, 1984–1999

RENÉ MORISSETTE, XUELIN ZHANG, and MARIE DROLET

Working Paper No. 396

www.levy.org/pubs/wp/396.pdf

Financial Globalization and Regulation

PHILIP ARESTIS and SANTONU BASU

Working Paper No. 397

www.levy.org/pubs/wp/397.pdf

Today, governments and firms borrow funds from all over the world. Potentially, international borrowing through banks or via capital markets offers developing countries a vast source of finance that could never be matched in an autarchic system. Capital raised on world markets can be used to enhance production capacity in countries that are not yet rich enough to finance their own expansion.

But even as regulatory barriers to cross-border lending have fallen in recent years, many nations have been unable to tap global capital markets. In fact, in 2002, the emerging markets as a group were net exporters of capital. In a new working paper, Institute Professor Philip Arestis and Santonu Basu of South Bank University, London, argue that a new set of global financial institutions are needed to help developing countries borrow more from world markets.

Arestis and Basu argue that international investors are reluctant to purchase bonds of emerging nations partly because the currencies of such countries do not always hold their value well against the world's "reserve currencies"—the yen, euro, and dollar. Even if a company earns substantial profits in the currency of the emerging market in which it is located, those returns do not necessarily translate into dollar profits for an American investor. For example, when the value of the Mexican peso collapsed in 1994, the Mexican government was unable to purchase enough dollars with its cash flows to make payments on loans that were denominated in dollars. International investors sometimes avoid making loans in certain areas of the world because they feel the probability of a similar debacle is high.

The authors argue that the threat of a currency collapse or a default on international debt leaves banks and investors so reluctant to lend that only major exporters, who earn profits in internationally accepted currencies such as the dollar, have access to world capital markets. A nation that exports goods to the United States can promise to pay back a loan using its export revenues. Also, exporters often have assets that are valuable enough to foreigners to be acceptable as collateral to foreign banks. But where does that leave companies and nations that lack export earnings? For them, the benefits of global capital markets are often meager.

Arestis and Basu argue that setting up an international central bank (ICB) with its own currency would help such firms and countries. The international currency unit (ICU) could be used to settle international transactions. The ICB would help ensure that individual nations' monies held their value against the ICU by lending countries ICUs when they were having temporary problems paying their bills. The ICB would also have some supervisory powers to prevent countries from getting into financial trouble in the first place. A sister agency to the ICB could provide funds for longer-term investment projects in emerging economies, allowing economies to progress even when private investors provided little assistance.

Inequality of the Distribution of Personal Wealth in Germany 1973–1998

RICHARD HAUSER and HOLGER STEIN

Working Paper No. 398

www.levy.org/pubs/wp/398.pdf

Working paper 398 was presented at the International Perspectives on Household Wealth conference at the Levy Institute. For a summary, please see page 7 of this *Report*.

Levy Institute News

New Website

The Institute has a new webmaster and a new website. The new site was developed by Horace G. Nelson Jr., and uses the xml language to make publications and other information accessible in a number of ways. The site has the same URL, or web address, as the old one: www.levy.org. Nelson is assisted by the new Institute web developer, Barbara A. Murphy.

Upcoming Event:

14th Annual Hyman P. Minsky Conference

Blithewood

Bard College

Annandale-on-Hudson, New York

April 23–24, 2004

Information will be posted at www.levy.org as it becomes available.

Publications and Presentations

Publications and Presentations by Levy Institute Scholars

PHILIP ARESTIS *Institute Professor of Economics*

Publications: “European Integration and the ‘Euro Project’” (with M. C. Sawyer), in J. Michie, ed., *The Handbook of Globalisation*, Cheltenham: Edward Elgar Publishing Limited, 2003; “Critical Realism and the Political Economy of the Euro” (with A. Brown and M. C. Sawyer), in P. Downward, ed., *Applied Economics and the Critical Realist Critique*, London: Routledge, 2003; “O euro e a UME: lições para o Mercosul” (with Fernando Ferrari-Filho, Luiz Fernando de Paula, and M.C. Sawyer), *Economia e Sociedade*, Vol. 12, No. 1, June 2003; edited and wrote the introduction (with Georgios Chortareas, Bank of England) for a special issue, “Transparency in Monetary Policy,” *Manchester School of Economic and Social Research*, Vol. 71, No. 5, September 2003; “Europe’s Imposed Stability, Now It Has to Create Growth” (with M. C. Sawyer), *The Guardian*, August 25, 2003; “Only Fiscal Activism Has the Power to Counter Recession, Because Central Banks Are Impotent” (with Dimitri B. Papadimitriou), *Financial Times*, August 29, 2003; “Wrong Policies Pulling Eurozone Economies Apart” (with M. C. Sawyer), *Financial Times*, September 8, 2003.

Presentations: “Aggregate Demand, Conflict, and Capacity in the Inflationary Process” (with M. C. Sawyer), Economics for the Future conference, University of Cambridge, September 17–19, 2003; “Reinventing Fiscal Policy” (with M. C. Sawyer), 7th International Workshop on Finanzpolitik in der Kontroverse, Berlin, October 24–25, 2003; “Macroeconomic Policies of the Economic and Monetary Union: Theoretical Underpinnings and Challenges,” University of Utah, November 7, 2003, and University of Denver, November 10; “Monetary Policies in the Eurosystem and Alternatives for Full Employment,” European Association for Evolutionary Political Economy annual conference, Maastricht, Netherlands, November 7–9, 2003; “What Is Wrong with the Euro Area Monetary Model?” International Conference on *The Monetary Theory of Production*, in honor of Augusto Graziani, University of Sannio, Italy, December 5–6, 2003.

WALTER M. CADETTE *Senior Scholar*

Presentation: “The U.S. Budget Problem,” Central Bank of Argentina, Buenos Aires, October 28, 2003.

ASENA CANER *Research Scholar*

Presentation: “Asset Poverty in the United States: Evidence from the Panel Study of Income Dynamics, 1984–1999” (with E. N. Wolff), Levy Institute conference on International Perspectives on Household Wealth, Annandale-on-Hudson, New York, October 17–18, 2003.

JAMES K. GALBRAITH *Senior Scholar*

Publications: “A Taste of Texas,” *Texas Observer*, June 6, 2003; “Socking It to the States,” *The Nation*, June 9, 2003; book review, “Working Within the System,” of *The Soul of Capitalism* by William Greider, in the *Washington Post Book World*, August 31, 2003; book review of *Rich Democracies: Political Economy, Public Policy, and Performance* by Harold L. Wilensky, in the *Journal of Economic Literature*, XLI, 3, September, 2003; “The Iraqi Quagmire,” *Texas Observer*, August 29, 2003; “Why Bush Likes a Bad Economy,” *The Progressive*, October 2003; “Doubting Out Loud,” *Texas Observer*, October 24, 2003; “Exit Strategy,” *Boston Review*, Vol. 28, No. 5, October–November 2003; “The Evolving Economics of War and Peace,” *Encyclopedia of Life Support Systems*, UNESCO, <http://www.eolss.net/E628Atoc.aspx>, 2003.

Presentations: “An Economy That Works for Working People,” panel at Take Back America conference, Washington, D.C., June 5, 2003; “Economics in Time of War and Empire,” plenary speaker at the International Confederation of Associations for Pluralism in Economics, Kansas City, June 6, 2003; “Economics in War-Time,” first meeting of the International Confederation of Associations for Pluralism in Economics, Kansas City, June 7, 2003; “A Program for Liberals,” Americans for Democratic Action, board meeting, June 28, 2003; “An Economic Program for Progressives,” Milton S. Eisenhower Foundation, June 30, 2003; keynote lecture, “America and the European Social Model,” Summer Institute on Alternative Economic Policy in Europe, University of Gottingen, Germany, July 22, 2003; “Economists and War,” American Agricultural Economics Association annual meeting, Montreal, July 28, 2003; “Military Expenditures and Inequality: Empirical Evidence from Global Data” (with Hamid E. Ali), Association for Budgeting and Financial

Management annual meeting, Washington, D.C., September 19, 2003; “Global Inequality and Global Policy,” Catholic Social Thought and Globalization conference, Villanova University, Villanova, Pennsylvania, November 7, 2003; “Regional Inequality and the Information Bubble” (with Travis Hale), Association for Policy Analysis and Management annual meetings, Washington, D.C., November 8, 2003.

DIMITRI B. PAPANIMITRIOU *President*

Publications: “Only Fiscal Activism Has the Power to Counter Recession, Because Central Banks Are Impotent” (with Philip Arestis), *Financial Times*, August 29, 2003. “The State of the U.S. Economy,” *Analyst*, The Institute of Chartered Financial Analysts of India, December 2003.

Presentations: Radio interview, *Streetwork Live* with host Lance Roberts, Business Radio 650, Houston, November 12, 2003; “Government Deficits and Growth,” Center for Full Employment and Price Stability conference, University of Missouri, Kansas City, November 17, 2003; radio interview with host Mike Norman, Business America Radio, November 19, 2003.

MALCOLM SAWYER *Senior Scholar*

Publications: “European Integration and the ‘Euro Project’” (with P. Arestis), in J. Michie, ed., *The Handbook of Globalisation*, Cheltenham: Edward Elgar Publishing Limited, 2003; “Critical Realism and the Political Economy of the Euro” (with P. Arestis and A. Brown), in P. Downward, ed., *Applied Economics and the Critical Realist Critique*, London: Routledge, 2003; “O euro e a UME: lições para o Mercosul” (with P. Arestis, Fernando Ferrari-Filho, and Luiz Fernando de Paula), *Economia e Sociedade*, Vol. 12, No. 1, June 2003; “Europe’s Imposed Stability, Now It Has to Create Growth” (with P. Arestis), *The Guardian*, August 25, 2003; “Wrong Policies Pulling Eurozone Economies Apart” (with P. Arestis), *Financial Times*, September 8, 2003.

Presentations: “Aggregate Demand, Conflict, and Capacity in the Inflationary Process” (with P. Arestis), Economics for the Future conference, University of Cambridge, September 17–19, 2003; “Reinventing Fiscal Policy” (with P. Arestis), 7th International Workshop on Finanzpolitik in der Kontroverse, Berlin, October 24–25, 2003; “Monetary Policies in the Eurosystem and Alternatives for Full Employment” and “Macroeconomic Policies of the Economic and Monetary

Union: Theoretical Underpinnings and Challenges,” European Association for Evolutionary Political Economy annual conference, Maastricht, Netherlands, November 7–9, 2003; “Can Monetary Policy Affect the Real Economy?” and “Unemployment, Inflation, and Money,” Seminar on Income Distribution and Monetary Policy, National Autonomous University of Mexico (UNAM), Mexico City, November 11–14, 2003.

ANWAR M. SHAIKH *Senior Scholar*

Publications: “Who Pays for the ‘Welfare’ in the Welfare State? A Multi-Country Study,” *Social Research*, Summer 2003; “Labor Market Dynamics within Rival Macroeconomic Frameworks,” *Growth, Distribution and Effective Demand*, Gary Mongiovi, ed., M.E. Sharpe, 2003.

EDWARD N. WOLFF *Senior Scholar*

Publications: “The Devolution of the American Pension System: Who Gained and Who Lost?” *Eastern Economic Journal*, Vol. 29, No. 4, Fall 2003; “The Levy Institute Measure of Economic Well-Being” (with A. Zacharias), *Indicators: A Journal of Social Health*, Vol. 2, No. 4, Fall 2003.

Presentations: *Biznet*, ABC television, New York, June 29, 2003; radio interview with Mich Otto, KTAR Radio, Phoenix, September 29, 2003; “The Transformation of the American Pension System,” CUNY Graduate Center, Economics Department, September 30, 2003; *CNN Money Morning* with Kathleen Hayes, October 2, 2003; *WHAM Morning News* with Chet Walker, Rochester, New York, October 3, 2003; “The Devolution of the American Pension System,” Russell Sage Foundation, New York City, October 15, 2003; “Asset Poverty in the United States: Evidence from the Panel Study of Income Dynamics, 1984–1999” (with A. Caner), Levy Institute conference on International Perspectives on Household Wealth, Annandale-on-Hudson, New York, October 17–18, 2003; *Bernie Sanders Show*, WDEV, Vermont, November 3, 2003.

L. RANDALL WRAY *Senior Scholar*

Publications: “Surplus Mania: A Reality Check,” *Macroeconomics*, Don Cole, ed., 14th edition, chapter 12, McGraw-Hill/Dushkin, 2002/2003; “Seigniorage or Sovereignty?” in *Modern Theories of Money*, Louis-Philippe Rochon and Sergio Rossi, eds., Cheltenham: Edward Elgar Publishing Limited, 2003; *Trabalho e Moeda Hoje: a chave para o pleno emprego e a estabilidade dos*

precos, Portuguese language edition of *Understanding Modern Money: The Key to Full Employment and Price Stability*, Editora UFRJ/Contraponto, 2003; “Social Security: Truth or Convenient Fictions?” and “Monetary Policy: An Institutional Approach,” in *Institutional Analysis and Economic Policy*, Marc Tool and Paul Bush, eds., Kluwer Academic Publishers, 2003; “The Neo-Chartalist Approach to Money,” in *The State, the Euro, and the Market*, Stephanie Bell and Edward Nell, eds., Cheltenham: Edward Elgar Publishing Limited, 2003; “Financial Instability,” in *An Encyclopedia of Macroeconomics*, Howard Vane and Brian Snowdon, eds., Cheltenham: Edward Elgar Publishing Limited, 2003; “Money,” in *The Elgar Companion to Post-Keynesian Economics*, John King, ed., Cheltenham: Edward Elgar Publishing Limited, 2003; “A History of Post-Keynesian Economics since 1936,” book review in the *Journal of Economic Literature*, September 2003; “Deflation Worries,” *Chartered Financial Analyst*, July 2003; “The Post-Keynesian Approach to Money” (in French), in *Theories Monétaires Post Keynesiennes*, Pierre Piégay and Louis-Philippe Rochon, eds., Paris: *Economica*, 2003; “Functional Finance and U.S. Government Budget Surpluses in the New Millennium,” in *Reinventing Functional Finance: Transformational Growth and Full Employment*, Edward Nell and Mathew Forstater, eds., Cheltenham: Edward Elgar Publishing Limited, 2003.

Presentations: “Is Euroland the Next Argentina?” University of Bergamo, Italy, June 24, 2003; “Currency Sovereignty and the Possibility of Full Employment,” 6th Congreso Nacional de Estudios del Trabajo, Buenos Aires, August 14, 2003; Argentinean Ministry of Finance and Labor (with Pavlina Tcherneva), August 13–15, 2003; press conference with Istanbul mayor (with Pavlina Tcherneva and Mathew Forstater) about a collaborative study of policy to create jobs, Istanbul, Turkey, November 3, 2003.

AJIT ZACHARIAS *Research Scholar*

Publication: “The Levy Institute Measure of Economic Well-Being” (with E. N. Wolff), *Indicators: A Journal of Social Health*, Vol. 2, No.4, Fall 2003.

Presentations: “Household Wealth, Public Consumption, and Economic Well-Being in the United States,” Economics for the Future conference organized by the Cambridge Journal of Economics, Cambridge, U.K., September 17–19, 2003; “Gender-Sensitive Statistics: Lessons from the United States,” IV

Encuentro Internacional de Estadística y Políticas Públicas Sensibles al Género en el Marco de las Metas del Milenio, conference organized by the UNIFEM, INMujeres (Mexico) and INEGI (Mexico), Aguascalientes, Ags., Mexico, November 3–5, 2003.

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