Scholars at a symposium on behavioral economics discuss their latest work and the future of the field.

- Participants at a Levy Institute workshop discuss the role of technology in earnings inequality.

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- President Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray argue that financing Social Security is not the real problem we face to provide for retirees in the future.

- The 1999 Levy Institute Survey of Small Business suggests that the minimum wage can be raised with few disemployment effects.

- Senior Scholar Steven M. Fazzari finds that a reduction of capital gains taxes would have minimal effects on capital formation and output and therefore on the growth of the U.S. economy.

CONTENTS
Workshops and Symposium

- Workshop on Earnings Inequality, Technology, and Institutions
- Association for Evolutionary Economics/Levy Institute Summer School on Institutional Economics
- Symposium on Behavioral Economics and Policy

New Working Papers

- Can Social Security Be Saved?
- Can Rescheduling Explain the New Jersey Minimum Wage Studies?
- Functional Finance and Full Employment: Lessons from Lerner for Today
- The Independent European Central Bank: Keynesian Alternatives

New Public Policy Brief

- Down and Out in the United States

New Policy Notes

- The Minimum Wage Can Be Raised: Lessons from the 1999 Levy Institute Survey of Small Business
- Capital Income Taxes and Economic Performance
- More Pain, No Gain: Breaux Plan Slashes Social Security Benefits Unnecessarily

Levy Institute News

- Seminar: Financing Full Employment
- New Members of the Levy Institute
- Commission Vice Chairmanship for Papadimitriou
- Upcoming Conference
- Book: Modernizing Financial Systems

Publications and Presentations

- Publications and Presentations by Levy Institute Scholars
Workshops and Symposium

Workshop on Earnings Inequality, Technology, and Institutions

A Levy Institute workshop on June 8 through 10 brought together scholars to examine the causes of a continuing and growing inequality in earnings in the United States despite several years of strong economic growth. The fifteen presentations at the workshop focused on the role of technology in the earnings gap. One theory is that since technological advancement creates a great demand for high-skill workers and little demand for low-skill workers, the income of high-skill workers is increasing, while that of low-skill workers remains stagnant.

Larry Mishel, of the Economic Policy Institute, presented evidence that although wage inequality grew in both the 1980s and 1990s, the reasons for the rise in inequality in the two periods were different. The most striking finding was that the 1990s growth rate of relative wages and of employment for male workers of varying education levels was the slowest it has been since the
1940s. This finding does not fit with the story usually given for rising wage inequality, namely, a rise in returns to education and technology-related skills. Steven Rose, of the Educational Testing Service, focused on employment categories and wages and asserted that it is not high-technology workers who have experienced the most gain in wages but high-level business professionals and managers.

Robert Margo, of Vanderbilt University, showed that wage inequality is not new. In his study of wages from 1820 to 1970, he found several periods of rising inequality as well as periods of declining inequality. In periods of declining inequality, especially those of the early 1900s, education seems to have played a role in narrowing the income gap.

Peter Berg, of Michigan State University, and Thomas Bailey, of Columbia University, also questioned the technology explanation for increased wage inequality. They examined work practices in several industries and found that workers in high-performance work systems (defined as systems that allow workers to be involved in problem-solving and decision-making aspects of the business) tend to be paid more than workers in other systems. This was not true of all industries, but Berg and Bailey argued that the findings indicate that work systems may play some role in wage inequality. Michael Handel, of Harvard University and the Levy Institute, and Maury Gittleman, of the Organization for Economic Cooperation and Development (OECD) and the Bureau of Labor Statistics, challenged Berg and Bailey's argument. Handel and Gittleman concluded in their study of high performance work systems that such systems may provide workers with a more interesting and pleasant work environment, but they do not necessarily pay higher wages.

Peter Cappelli, of the University of Pennsylvania, offered other possible causes for wage inequality. His research on wage determinants suggested that many firms are paying higher wages not to attract more skilled workers, but to encourage employees to work harder and to foster employee loyalty.

Todd Idson, of Columbia University, discussed research that has shown that wages vary by firm size. Wages tend to be higher in larger firms than in smaller firms. Idson's research supports productivity theory as an explanation for this wage differential. In general, larger firms are adopting new technology more rapidly than smaller firms. As a result their demand for skilled workers is increasing. This would seem to indicate that technological advancement has played a role in increasing the demand for, and therefore the wages of, high--skill workers--a position that was challenged by Michael Handel in his second presentation. Handel argued that the largest increase in inequality (in the early 1980s) preceded the spread of computerization in the workplace.

Andrew Glyn, of Corpus Christi College, Oxford University, examined the problem of inequality from an international perspective. Although findings vary by country, some generalities emerge from his study of OECD countries. When unemployment increases, those at the bottom of the income and education ladder tend to suffer greater employment losses than those at the top; increased imports from lower-wage countries hurt mostly workers at the low end of the wage scale; and workers in nations with centralized bargaining systems seem to fare better than workers in nations without such systems. David R. Howell and Ellen Houston, both of the New School for Social Research, returned to the issue of the role that skill plays in earnings inequality. Much research on skill looks at
workers by educational, industry, or skill category. Howell and Houston analyze by occupation level, which, they argue, allows for more detail on what workers actually do in various jobs and what skills they actually need for those jobs. Their preliminary research indicates that increased wage inequality is only partly explained by increased demand for high-skill workers relative to low-skill workers. Other factors, such as immigration and declining value of the minimum wage, may also contribute to inequality.

Markus Jäntti, of Åbo Akademi University in Finland, agreed with other presenters that technology was not the sole driving force behind increased earnings inequality. His research indicates that Finland has experienced a growing wage gap since the early 1980s, but not an increase in the demand for high-skill workers. Jäntti said research into the role of unions and Finland's collective bargaining system might shed more light on the causes for the increased inequality. Steven Machin, of University College in London, presented research that suggests that the demand for high-skill workers, as measured by educational level, may be increasing. Machin examined 16 industries in several countries and found that, in general, there is a trend toward higher education among employees. Specifically, an increasing proportion of employees in these industries are college graduates.

Edward N. Wolff, of New York University and the Levy Institute, returned to the role of computerization in earnings inequality. He presented research findings that indicate a link between investment in computerization and earnings inequality; both increased at the same time. Wolff also seeks to address a paradox—a general societal improvement in education and skills has not been matched by increased earnings. His research indicates that most of the growth in earnings inequality is due to increases of inequality at the industry level and relatively little is due to interindustry shifts in employment, that is, from high-skill to low-skill industries.

Robert Pollin and Stephanie Luce, both of the University of Massachusetts Amherst, presented the findings of their study of the likely effects on businesses of a proposed increase in the minimum wage in New Orleans to $6.15 an hour, a dollar above the federal minimum wage. They concluded that many businesses would not be affected at all, some might respond by raising prices, and few would be affected to the degree that they would relocate outside the city. In a followup to this issue, Oren M. Levin-Waldman, of the Levy Institute, discussed similar results from the Levy Institute Survey of Small Business. Responses indicated that many businesses would not be adversely affected if the federal government were to raise the minimum wage.

In the final presentation Conchita D'Ambrosio, of Boconi University in Milan and New York University, discussed inequality in Italy. She has found that more educated and older workers earn more and attributes some of this to changes in the nation's wage bargaining system. Collective bargaining has decreased and as a result different groups bargain separately. It may be that older and more educated workers are more successful at bargaining.

Association for Evolutionary Economics/Levy Institute Summer School on Institutional Economics
The Levy Institute, in conjunction with the Association for Evolutionary Economics (AFEE), organized a summer school program, held on June 20 to 23, to introduce graduate students to the theories and methods of institutional (or evolutionary) economics, their application to research, and the institutional view of corporate capitalism and the development of institutions.

**Day 1: Introduction to Institutional Economics**

Marc R. Tool, professor emeritus of economics at California State University in Sacramento, began the program by describing the difference between orthodox economics and institutional economics, which looks to Thorstein Veblen and John R. Commons as two of its key founders. Institutional economics is a field of study that incorporates value judgments and draws on other fields, such as political science and sociology, to develop a more comprehensive approach to the study of economic problems. Institutional economists are not afraid to ask what ought to be and they believe that economic structures can be changed. They address the real world and the structural problems that impair, preclude, corrupt, or even destroy the institutions through which a society generates and distributes income and products.

Tool said that institutionalists do not believe that there are natural forces "out there" that will restore the economic system to equilibrium if only people and governments would get out of the way. The forces that determine economic structure come from within a society, and people and their governments have choices about how the economic structure is shaped. Institutional economists place great emphasis on the study of power--who wields it and how power holders use it to create an economic structure that benefits themselves.

Anne Mayhew, associate dean for academic programs at the University of Tennessee, said that institutions are the primary unit of analysis in institutional economics. She defined institutions as patterns of thought and behavior common to a group of people within a nation or other geographic region. These patterns can change over time. (It is for this reason that institutional economics is also known as evolutionary economics.) Mayhew said that economic analysis that separates "economics" from all other aspects of society is inadequate because it fails to consider other important factors in society, such as the political and social processes.

The importance of the role of patterns of thought and behavior, or culture, in the field of institutional economics was emphasized by William Waller, professor of economics at Hobart and William Smith Colleges, and William M. Dugger, professor of economics at the University of Tulsa. They said that the institutional methodology requires that one consider culture and process. For example, the economy is the "process" of social provision and it is this process that should be studied. Waller and Dugger said that, unlike orthodox economists, institutionalists will approach a research problem asking not only how things are, but how they ought to be. They are also not afraid to create their own categories for analysis. All categories are created by people and therefore can be changed by people. Waller and Dugger warned students not to become wedded to their own categories. Categories that served them well in the past may become meaningless over time. Dugger also suggested that economic researchers should follow the approach of Commons and simply go out and talk to people. This is an effective method for those who want to know what is really going on in an economic system.
Day 2: Inequality

The second day of the summer school was devoted to the application of the institutional approach to the study of income inequality. Janice Peterson, associate professor in the Department of Economics at the State University of New York College at Fredonia, said a fundamental difference between orthodox and institutional economists is their notion of scarcity. Orthodox economists believe that resources may be scarce and that the economic system acts as the allocator of scarce resources. Institutionalists argue that evolution in the economic process and new developments can turn formerly useless resources into useful ones. Thus, institutionalists do not measure economic outcomes only in terms of their efficient allocation of resources, but in terms of how those outcomes allow for the continuation of human life and development. Orthodox economists view the system in terms of trade-offs and argue that sometimes the few must be made worse off so that the greater number can be made better off. Institutionalists believe that deprivation of income prohibits individuals from participating in the economy and community and that this should be defined as a failure of the economic system. Thus, wealth inequality, which deprives some of income, is a system failure. It is the responsibility of government, as an integral part of the economic and social provisioning process, to redistribute wealth.

Dugger said that to understand the problem of inequality, one must examine how systems of power allow one group to dominate another. He defined four modes of inequality--gender, race, class, and nation. A mode is the way a system of power predetermines winners and losers. Each mode has an enabling myth and each has an antidote to that myth. For example, with regard to gender inequality, the myth is that women are by nature inferior. If men and women are both taught this myth, men are given rein to dominate women and women are encouraged to tolerate that domination. The antidote is feminism--essentially thinking about the gender relationship in a different way. Institutionalists consider these power systems in their study of inequality.

According to Wallace C. Peterson, George Holmes Professor of Economics emeritus at the University of Nebraska, when orthodox economists study the allocation of resources, such as wealth, they focus on competition in the marketplace. Institutionalists focus not only on competition, but also on power. There are three main players in the marketplace--capitalists and laborers on the supply side and buyers on the demand side. All want power over the marketplace, all want to control the terms under which exchange takes place, and all want control over government because it sets the terms. Peterson said inequality increased in the late 1970s because the balance of power in the marketplace shifted toward the capitalist, or corporate, group. It is the inclusion of the study of power that helps institutionalists better understand issues such as inequality.

Four other scholars involved in research on inequality provided students with an overview of their work and its link to the institutional approach. Christopher J. Niggle, professor of economics and department chair at the University of Redlands, discussed his research on monetary policy and the role it has played in increasing inequality. Mathew Forstater, Levy Institute visiting scholar, discussed the contribution the institutional approach can make in understanding the link between race and inequality; institutional economics addresses the problem of domination and can provide insight into how it can be overcome. Steven B. Pressman, professor of economics and finance at Monmouth University, said that the institutional method of examining policies and institutions enabled him to explain why poverty rates vary so much among the developed nations he
is studying. **Ellen Houston**, research fellow at the Center for Economic Policy Analysis at the New School for Social Research, is challenging the neoclassical argument that technological change creates wage inequality because it increases the demand for and therefore the wages of skilled labor. Her study, which focuses on skills in specific occupations, indicates a diminishing effect of skill on wages.

The second day of the summer school ended with a roundtable on the problem of inequality. Marc-André Pigeon, Levy Institute research assistant, described the failure of the recent economic boom in the United States to raise employment and income of low-skill workers. **Oren M. Levin-Waldman**, Levy Institute resident scholar, discussed the impact of regional differences in wage structure in the United States on support for increases in the minimum wage. **Charles M. A. Clark**, professor of economics at St. John's University, and **Karl Widerquist**, Levy Institute resident research associate, discussed the role a guaranteed income policy could play in alleviating poverty. **L. Randall Wray**, Levy Institute senior scholar, presented a proposal for increasing employment—a "government as employer of last resort" plan in which the government provides the opportunity to work to all those willing and able to work.

**Day 3: Financial Fragility**

Wray began the examination of the institutional approach to the study of financial systems and capitalism with a discussion of Hyman P. Minsky's work on capitalist systems. The orthodox economic view is that institutions create instability in a capitalist system because they interfere with the system. Minsky argued, to the contrary, that capitalism is by nature unstable and that institutions, specifically big government and big banks, play a vital role in maintaining stability. The success of these institutions in maintaining stability, however, causes players in the financial system to take more risks, which generates instability. It is necessary for the institutions to adapt to such changing situations in order to maintain stability.

According to **Walker F. Todd**, an attorney and economic consultant, the institutions discussed by Wray may be needed to maintain stability, but one must also consider the power that they may acquire. Powerful institutions can present a danger to society if society cannot control them, and it is possible for certain groups to gain power in society by gaining control of institutions. Todd cited as an example the International Monetary Fund, an institution that assumed unnecessary power after the collapse of the financial system set up by the Bretton Woods agreement.

In a discussion of economic forecasting, **Wynne Godley**, Levy Institute distinguished scholar, said that the key is to look at the present. If one looks at a house on the ocean and sees that the foundation is being washed away, one can predict that the house will fall, although one might not be able to say exactly when. The same applies to economic forecasting. For example, the current situation of a deteriorating balance of payments and rising private debt in the United States indicates that the nation's economy will stutter at some time in the near or intermediate term. The situation can, however, be changed. Just as the foundation of the house can be repaired before it collapses, U.S. fiscal and trade policy can be changed to alter the future.

The third day closed with a roundtable on the recent financial crises throughout the world. **Ilene Grabel**, assistant professor of economics at the Graduate School of International Studies at the
University of Denver, discussed the financial crisis in Mexico in the mid-1990s and the Asian crisis of 1997. She rejected the orthodox economic view that both crises were exceptional cases that were caused by such things as mismanagement of the financial systems and corruption. Drawing on institutional theories of power, Grabel argued that these crises resulted from the ability of economic elites to push nations to liberalize their financial systems.

**David Zalewski**, associate professor of finance at Providence College, discussed South Korea after the crisis. Although it appears to be making an economic comeback--its gross domestic product is rising and there is renewed activity in its financial system--it is a long way from recovery. Most of the economic activity is the product of large corporations, many of which have not undergone needed reforms. Smaller businesses are not doing well, partly because they have had a more difficult time getting credit to keep operating. And while unemployment data indicate improvements, such data do not capture the real picture of household income and economic well-being, which is that families are cutting back on expenditures for such things as health and education. Zalewski predicted that South Korea will face another crisis if it fails to reform its system.

Listening to the advice of western nations and the International Monetary Fund might not be wise for nations hit by the recent financial crises, said **Frank A. J. Veneroso**, manager of a global investment strategy and money management firm. Those nations that followed the advice of the IMF and raised interest rates went deeper into crisis than did those nations that actively intervened to gain control over banks and the financial system, and nations that intervened seem to be recovering faster. Asian nations tended to have high rates of saving and low rates of investment, which resulted in low profits, but they remained stable until they opened their economies. This made them vulnerable to exogenous shocks that set off the crisis. Recovering from the crisis will not be easy because many Asian nations have accumulated large debts that cannot easily be disposed of.

**Day 4: Corporate Capitalism**

On the final day of the summer school program participants examined the institutional view of the modern business corporation. Mayhew said that, unlike neoclassical economists, institutionalists do not believe there is one theory of "the firm." Instead, they believe there are many varieties of firms and they change over time. The two economic approaches also differ in their explanations of why large corporations developed. Orthodox economists tend to attribute firm growth to economies of scale. Institutionalists argue that although economies of scale might help an individual firm become more efficient, that does not translate into improved efficiency for society. They tend to view a firm's growth as a result of its efforts to gain control over all phases of production and distribution. The efficiency that results allows those making money from the firm to make more money.

**Glen Atkinson**, Foundation Professor of Economics at the University of Nevada, returned to the idea that institutional economics is evolutionary economics. Institutions change over time and small changes add up to large, structural changes. These changes are not the result of natural selection but of conscious choices. Because things change, theorists must recognize that their theories must also change. Atkinson gave as an example of structural change the development within the European Union of the Court of Justice, which now has the power to enforce European law over national law. The decision to create new institutions and destroy old ones is important, and researchers should pay more attention to this process.
Symposium on Behavioral Economics and Policy

On July 7 and 8 the Levy Institute hosted a symposium on behavioral economics organized by James Rebitzer, of Case Western Reserve University.

Linda Babcock, of Harvard Business School and Carnegie Mellon University, and Lowell J. Taylor, of Carnegie Mellon University, presented "The Scales of Justice: The Effect of Cap Magnitude on the Likelihood of Pre-Trial Settlement," which was part of a joint research project with Greg Pogarsky, also of Carnegie Mellon University. They are examining the effect of trial award size limits on the likelihood that disputes will proceed to a trial. Their research indicates that in some cases caps on awards increase the settlement rate, but in other cases they can reduce it. The reduction is more likely if the cap is set at a level that is high relative to the amount the plaintiff is asking for.

David Schkade, of the University of Texas at Austin, presented "Shared Outrage and Erratic Awards: The Psychology of Punitive Damages," which was part of a joint research project with Daniel Kahneman, of Princeton University, and Cass R. Sunstein, of the University of Chicago. In their study of punitive damages awarded by juries in personal injury cases, they sought to understand why there is often substantial agreement among jurors on the outrageousness of a defendant's actions and on the appropriate severity of punishment, but rarely on the dollar amount that should be awarded. The researchers conclude that jurors find it difficult to convert their sense of outrage into a dollar value and that providing them with some sort of reference point might help them make this conversion.

Iris Bohnet, of the Kennedy School of Government at Harvard University, presented "More Order with Less Law: On Contract Enforcement and Crowding," written with Steffen Huck, of Humboldt University. Their research employed a game model in which one person must decide whether to enter a contract without knowing if the second person will honor that contract. Standard economic analysis of law predicts that the higher the expected cost of breaching the contract, the more likely the second person will perform. Bohnet and Huck found that when it is unlikely that the legal system will enforce a contract, the first person will enter a contract only if he or she trusts the second person and this can motivate the second person to become more trustworthy. When it is highly likely that the legal system will enforce a contract, interpersonal trust is replaced by institutional trust. The first person enters a contract because the legal system prevents the second person from breaching it.

In "Near Rational Behavior and the Long-Run Phillips Curve," William Dickens, of the Brookings Institution, looked at firm and individual behavior in the face of inflation. When inflation is low, firms tend to ignore it when setting prices and employees tend to ignore it when negotiating for wages, but when inflation is high, both tend to take it into account. However, even when firms adjust for inflation, the prices they set tend to lag behind inflation because they fail to adjust for what the rate of inflation may be in the next business period. Thus, prices tend to lag behind inflation by one business period. The profits lost as a result are minimal when inflation is low, but are high when inflation is high.
Sendil Mullainathan, of the Massachusetts Institute of Technology, presented "A Memory-Based Model of Bounded Rationality." Drawing on the fields of biology and psychology, Mullainathan showed that memory may limit rationality in decisions on consumption and asset pricing. Memories shape individuals' knowledge of an issue and affect their decisions. However, memories and assumptions based on them are not always accurate. For example, memories of unemployment or a pay raise will shape individuals' predictions of the likelihood of becoming unemployed again or expectations of future income. A person who recently received a large raise may forget (or disregard) that past raises were small and assume that income will increase by large amounts in the future. This expectation of a higher income, even though it is inaccurate because it assumes future large raises, could cause the person to decide to increase consumption. Thus, memory has its limits and also can be manipulated to affect economic behavior.

In "Sect, Subsidy, and Sacrifice: An Economist's View of Ultra-Orthodox Jews" Eli Berman, of Boston University, asked why many Ultra-Orthodox Israeli men study in a yeshiva until age 40 or older rather than work to support their families, even though many of these families live in poverty. Berman found that Iannaccone's club model provides an explanation. The Ultra-Orthodox community provides mutual insurance to all of its members on the condition that they show a willingness to sacrifice for the community. Choosing yeshiva study over work that could lift their families out of poverty signals Ultra-Orthodox men's commitment to the community. Berman said that government policies that subsidize yeshiva attendance also play a role in encouraging men to remain in the yeshiva.

George Loewenstein, of Carnegie Mellon University, presented "Projection Bias in Predicting Future Utility," written with Ted O'Donoghue, of Cornell University, and Matthew Rabin, of the University of California at Berkeley. The authors find that individuals' present preferences are projected into the future and affect decisions that hinge on predictions of their future preferences. For example, an individual making summer vacation plans while experiencing a cold winter is likely to predict that he or she will prefer a tropical vacation in the summer. Individuals often are wrong in their predictions of future preferences and often underappreciate the degree to which intense feelings about their current preferences will dissipate. Since decisions based on future predictions may be difficult or costly to reverse, reducing projection bias through a "cooling off" period, in which to reconsider predictions, may be of benefit.

Eldar Shafir, of the Department of Psychology and the Woodrow Wilson School of Public and International Affairs at Princeton University, presented "On the Pursuit and Misuse of Useless Information," written with Anthony Bastardi, of Stanford University. Shafir and Bastardi found that people, to resolve uncertainty in decision making, will often search for information that seems relevant but is not at hand, even when, had that information been known at the outset, it would have had no impact on their decision. They then use that initially irrelevant information in making their decision. The pursuit of the information adds greater weight to the information than it would have received had it been initially available. Shafir gave as an example a situation in which a committee accepts a graduate school candidate with a B average, but then finds another set of records for that candidate indicating an A average. The committee holds off on its final decision while it seeks to learn which grade average is correct, even though it had said it would accept the student when it thought the student had a B average. Having chosen to pursue this additional information, the
committee then uses it in making its decision and decides to reject the student when the correct record turns out to be the lower average.

The symposium closed with a roundtable on the future of the field of behavioral economics. Participants agreed that the amount of research done should be increased to elevate the field's standing in the general area of economics. They also agreed that instructional materials in the field should be developed to encourage its inclusion in college economics courses in order to draw more students into the field. Some participants added that researchers should seek to address more relevant policy issues to bring the behavioral economics approach to the attention of policymakers.

Back to Contents

New Working Papers

Can Social Security Be Saved?
Dimitri B. Papadimitriou and L. Randall Wray
Working Paper No. 270

Calls for the reform of the Social Security system are based on projections that the system will face a financial crisis in the near future. In this working paper President Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray argue that the system is not facing a crisis. Any financial problems that might arise will be far in the future and any problems that do arise will be easily resolved then.

The authors argue that the real problem in providing for future retirees is not the financial status of the Social Security system now or in the future but the size and distribution of the economic pie in the future. Once this is recognized, it becomes clear that none of the popular reforms, such as privatization, reduction of current benefits, and "setting aside" budget surpluses, will have any effect on our ability to care for retirees. Papadimitriou and Wray present policy recommendations that they feel are consistent with the true nature and scope of the future problem.

Can Rescheduling Explain the New Jersey Minimum Wage Studies?
Thomas R. Michl
Working Paper No. 271

In a study on the effects of the increase in the New Jersey state minimum wage in 1992, David Card and Alan Krueger found that the number of fast-food restaurant workers increased. In another study,
David Neumark and William Wascher found that the total payroll hours of restaurants declined, which they took as an indication of a reduction in employment. In this working paper Thomas R. Michl, of the Department of Economics at Colgate University, shows that these findings are not necessarily contradictory.

Michl argues that since total payroll hours are the product of the number of workers and their average work hours, it is algebraically possible for the number of workers to remain constant or even increase while weekly hours per worker decline. He uses a model of demand for workers and weekly hours per worker that predicts that firms may substitute workers for hours per worker after a wage increase. The findings of both studies are consistent with this prediction of rescheduling of work hours. Michl concludes that the New Jersey minimum wage increase redistributed income effectively to the targeted population by raising wages; although it did reduce weekly hours per worker by just over one hour, the increase offset the loss of hours and it did not cause job loss.

**Functional Finance and Full Employment: Lessons from Lerner for Today**
Mathew Forstater  
Working Paper No. 272

An atmosphere of impending crisis created by recent economic developments--volatility on Wall Street, weakness in the European Union, deflationary pressures in the global economy--has led to serious questioning of mainstream economic theory and policy. The failure of orthodox views to offer satisfactory explanations of the causes of crisis or effective remedial policy approaches is good reason to look to the work of unorthodox thinkers of the past who attempted to formulate solutions to the challenges of modern capitalist economies. Visiting Scholar Mathew Forstater finds lessons in the work of Abba Lerner on functional finance and full employment that are as relevant today as when they were put forward five decades ago.

Basic to Lerner's ideas is the principle of functional finance. The state has the ability to promote full employment, price stability, and a decent standard of living for its citizens and it is its responsibility to fulfill these fundamental macro-economic goals. Fiscal measures should be judged by the way they function in society, not by their compliance with any economic dogma; no measure--taxing or spending, borrowing or lending, buying or selling--is good or bad in itself or an end in itself; it is only a means to achieve the fundamental goals.

**Savings-Recycling Public Employment: An Assets-Based Approach to Full Employment and Price Stability**  
Mathew Forstater  
Working Paper No. 273
Despite several years of a booming economy and a low rate of unemployment, unemployment has not been eliminated in the United States. As part of an effort to find a solution to this problem, Visiting Scholar Mathew Forstater draws on the budgetary and employment implications of William Vickrey's assets-based approach to macroeconomic analysis.

According to Vickrey, the relation between desired and actual holdings of net financial assets (or net nominal savings) is a crucial factor in macroeconomic processes. The government budget is the key policy instrument in the necessary recycling of net nominal savings to bring the desired and actual levels into equality at the full employment level of output and income: government deficits can close the gap between desired and actual levels of net nominal savings. Vickrey's analysis of the investment-saving relationship led him to view private sector investment as a means whereby saving is recycled back into the income stream. He believed that the major task for economists and policymakers was to devise the means whereby the necessary recycling of net nominal savings can take place without unexpected changes in the rate of either inflation or deflation. Forstater proposes government deficit-financed guaranteed public employment as an automatic stabilizing policy instrument capable of serving as such a means.

The Independent European Central Bank: Keynesian Alternatives
Philip Arestis
Working Paper No. 274

Visiting Senior Scholar Philip Arestis finds that a European clearing agency (ECA), similar to that envisaged by Keynes for the international economy, although not a panacea for the economic problems of the European Union, would be better than the proposed independent European central bank (ECB). The control of inflation--the primary objective of a central bank--should be only one policy goal among many. The principal goal should be achieving and maintaining high growth rates and full employment, a task that can be better performed by a clearing agency.

According to Arestis, Keynesian monetary and fiscal theory holds that the power of financial institutions is their ability to provide credit, which affects firms' investment plans, and this is a function an ECA could perform. He also proposes the creation of a European investment agency (EIA) that would be run by and controlled by the ECA. The twin institutions could take on the roles of providing credit to member countries to finance expansion and of ensuring that the burden of any balance of payments adjustments falls on both deficit and surplus countries.
Down and Out in the United States
Marc-André Pigeon and L. Randall Wray
Public Policy Brief No. 54

Despite a long period of strong economic growth, more than 28 million working-age persons were categorized by the Bureau of Labor Statistics as out of the labor force in 1998. A small portion of this population will move into the labor force, but the majority will remain without work. This brief examines the demographics of the out of the labor force population, their reasons for not working, the likelihood that they will move into the labor force, and the adverse effects on them of prolonged joblessness. Current labor market policies, and especially welfare reform measures, have proved ineffective for the "hard-core" jobless because the policies are predicated on the mistaken notion that the private labor market is dynamic and flexible enough to accommodate anyone who wants to work. A public employment program would complement the operation of the private market, providing those who are able and willing with income, a sense of worth, the opportunity to make a social and economic contribution, and preparation for entry into the labor force.

New Policy Notes

The Minimum Wage Can Be Raised: Lessons from the 1999 Levy Institute Survey of Small Business
Oren M. Levin-Waldman
Policy Note 1999/6 In the 1998 Levy Institute Survey of Small Business, most of the respondents said that their hiring and employment practices were not affected by the increase in the minimum wage to $5.15 per hour in September 1997. Their responses also suggested that even an increase to $6.00 per hour would not cause them to alter their practices. As part of a second survey, in 1999, the Institute attempted to learn how high the minimum wage could be before it began to have significant disemployment effects. In this policy note Resident Scholar Oren M. Levin-Waldman presents the survey results relevant to this question. The percentage of firms that said they would be affected by a minimum wage increase to $6.00 per hour declined from 20.7 percent in 1998 to 13.4 percent in 1999. When asked about an increase to $7.25 per hour, 35.8 percent of businesses said they would be affected. These and other findings lead Levin-Waldman to conclude that the minimum wage could be raised to at least $6.00 and perhaps as high as $7.25 per hour.

Capital Income Taxes and Economic Performance
Steven M. Fazzari
Policy Note 1999/7
The claim that high taxes on capital gains inhibit economic growth is often used to justify tax cuts on capital income, a tax policy that is regressive in that it benefits mainly the wealthy. Senior Scholar Steven M. Fazzari points to three problems ignored by advocates of these cuts. First, tax reform operates on capital formation by changing the user cost of capital. However, even if tax policy can lower the financial component of the cost, it cannot lower the depreciation component, and so it can do little to lower the overall cost of capital. Second, no credible link has been established between the cost of capital and capital formation. Third, an increase in the capital stock in itself does not necessarily lead to higher output.

Fazzari concludes that tax reform that reduces rates on capital income, even if it can reduce the cost of capital, will have at best minimal effects on capital formation and output and therefore on the growth of the economy. The small possible gain in higher output cannot offset the important social costs of a regressive tax policy.

More Pain, No Gain: Breaux Plan Slashes Social Security Benefits Unnecessarily
Dimitri B. Papadimitriou and L. Randall Wray
Policy Note 1999/8

In this policy note President Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray examine two proposals to reform Social Security. The Bipartisan Social Security Reform Plan was hailed by Senator John Breaux (Dé-La.), one of its creators, as a plan that would keep Social Security solvent for more than 75 years without increasing the payroll tax. It would do so by privatizing part of the program, creating a government-subsidized savings plan for young children that could be rolled into Social Security, reducing cost-of-living adjustments such that total benefits would not increase as fast as the consumer price index, extending the number of years of earnings used to calculate benefits from 35 to 40, and lowering benefits as projections of life expectancy rise. President Clinton's proposal would "lock away" in the Social Security Trust Funds more than 60 percent of the general budget surpluses projected for the next 15 to 25 years. Papadimitriou and Wray conclude that neither plan would provide much gain and the Breaux plan would actually cause pain in the form of unnecessarily reduced benefits.

The authors assert that Social Security does not face a financial crisis. The prediction of a crisis is based on overly pessimistic assumptions about revenues and costs, but even if the prediction were to come to pass, the resulting financial shortfall could be resolved by relatively minor adjustments in the tax system at that time. The gap between Social Security revenues and expenditures is projected to grow by slightly more than 2 percent of GDP by 2075. Thus, the shift of society's output to Social Security that would be required would be only 2 percent of output, and such shifts have been made in the past without generating economic crises. Cutting benefits now simply lowers living standards prematurely without in any way reducing burdens on future workers.

Back to Contents
Levy Institute News

Seminar: Financing Full Employment

In a seminar on June 16 Tony Aspromourgos, of the Department of Economics at the University of Sydney, and Stephanie Bell, of the New School for Social Research, discussed the financing of full employment programs such as the employer-of-last-resort program proposed by Senior Scholar L. Randall Wray. Wray's program calls for the government to hire, at a set wage, all those willing and able to work. Although such a program may generate persistent government deficits, Wray has said that this is not a serious problem because, essentially, the government finances its spending by "creating" money. Bell, supporting Wray's position, argued that as long as a country creates and controls its own money, it does not matter how much debt it incurs. Aspromourgos disagreed. While he supports the idea of a government commitment to employ all those seeking work, he believes that such a large-scale employment program would result in unsustainable debt and that this would adversely affect the economy.

New Members of the Levy Institute

Martin L. Leibowitz, vice chairman and chief investment officer with TIAA-CREF Investment Management, Inc., has joined the Levy Institute Board of Advisors. Prior to joining TIAA-CREF, he was with Salomon Brothers, Inc., where he served as a managing director, the director of research for fixed income and equities, and a member of the executive committee. He earned a Ph.D. in mathematics from the Courant Institute of New York University.

Michael Handel has become a Levy Institute resident scholar. His work here will be in the field of labor economics. Handel received a Ph.D. in economics from Harvard University.

Austin Matthew Richards is a new Cambridge University Visiting Scholar. While at the Levy Institute, he will be engaged in a study of ethical investment that draws on macroeconomics, political science, and ethics. Richards received a B.A. in history from Christ's College, Cambridge University.

Commission Vice Chairmanship for Papadimitriou

President Dimitri B. Papadimitriou has been selected as vice chairman of the Trade Deficit Review Commission, a bipartisan congressional panel that will examine the effect of the U.S. trade deficit on
the economy and propose ways to decrease the deficit. Murray Weidenbaum, of Washington University in St. Louis and former chairman of the Council of Economic Advisers, will serve as chairman of the commission.

Upcoming Conference

The Macrodynamics of Economic Inequality
October 28-29

The objective of the conference is to exchange new research results and ideas on economic inequality and the relationship between inequality and unemployment, economic growth, and economic development in the developed and the developing worlds. The conference is being coordinated by Senior Scholar James K. Galbraith and sponsored jointly by the Levy Institute and the Ford Foundation through the University of Texas Inequality Project. Program and registration information will be posted on the Levy Institute web site, www.levy.org, as it becomes available.

Book: Modernizing Financial Systems


Since the 1980s the financial system of the United States and to some extent that of other countries have undergone many changes--uniform capital requirements have been instituted, regulations have been eased, and market share consolidation of firms in the financial services business has been allowed. But more substantive reforms are necessary to avert crises such as those that have recently occurred in Japan, Korea, and other Asian countries.

Financial and technological innovations have brought new dimensions of credit risk, requiring sophisticated skills of bank manager and regulator alike. The modernization of the financial system must reflect the changing and competitive nature of the market and be framed in a regulatory and supervisory environment that, first, ensures the safety of the payment system and, second, offers incentives for prudent risk-taking and sound portfolio investments. This book offers a number of policy avenues that merit serious consideration.

Publications and Presentations
Publications and Presentations by Levy Institute Scholars

Distinguished Scholar Wynne Godley


Chairman S Jay Levy and Senior Scholar Walter M. Cadette


Senior Scholar Steven M. Fazzari


President Dimitri B. Papadimitriou


Senior Scholar L. Randall Wray


Research Associate Edward N. Wolff

Visiting Scholar Mathew Forstater

Cambridge University Visiting Scholar James N. Miller

Resident Research Associate Karl Widerquist

Resident Research Associate Lynndee Kemmet

Back to Contents