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Laurence H. Meyer, member of the Board of Governors of the Federal Reserve System, was a speaker at the Levy Institute's seventh annual conference on financial structure.

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- Mismeasurement of the consumer price index has led many to believe falsely that U.S.

productivity has slowed in the past 20 years, argues Leonard Nakamura, an economic adviser at the Federal Reserve Bank of Philadelphia.

- The future of the U.S. economy depends on wise investments in public infrastructure, asserts Visiting Scholar David Alan Aschauer.
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The Jerome Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan, independently funded research organization devoted to public service. Through scholarship and economic forecasting it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

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Seventh Annual Conference on Financial Structure

Developments in the Financial System: National and International Perspectives

The Levy Institute held its seventh annual conference on financial structure on April 10 and 11 at Blithewood. The conference, which has been renamed the Hyman P. Minsky Annual Conference on Financial Structure in honor of the distinguished scholar who passed away last October, attracted financial experts from government, private industry, and academia. The five featured speakers were **James D. Kamihachi,** senior deputy comptroller for economic and policy analysis at the Office of the Comptroller of the Currency, U.S. Department of the Treasury; **Charles Freedman,** deputy governor of the Bank of Canada; **Laurence H. Meyer,** member of the Board of Governors of the Federal Reserve System; **Jack Metcalf,**, member of the U.S. House of Representatives; and **John D. Hawke Jr.,** undersecretary for domestic finance at the U.S. Department of the Treasury. The five sessions were Financial Services Competition and Regulation; Recent Developments in International Banking; Consumer Finance, Debt, and Risk Management; Federal Reserve Policy's Effects on the Efficiency and Stability of Financial Markets; and Financial Services, Markets, and Public Policy. The participants' remarks are summarized here.

The United States is not in the midst of a banking crisis, but many conference speakers said that is not a reason not to reform the system. U.S. Representative Jack Metcalf, a member of the House Committee on Banking and Financial Services, said that the best time to reform the system is when things are quiet and there is time to examine all the options for reform. But this is no easy task. There is no agreement in Congress, the regulatory agencies, or the financial services industry on what reforms should be undertaken or even if reforms are needed. How best to secure the future of the U.S. financial structure was a central theme at this year's conference.

James D. Kamihachi

Kamihachi discussed changes that technology and management decisions are likely to bring about in the financial structure. He pointed out that banks face two structural options--vertical integration or contracting out for services. Currently, the commercial banking industry is one of the most vertically integrated industries, meaning that banks tend to handle all aspects of financial services. But this appears to be changing, especially with new technology. For example, ATM machines are sprouting everywhere, but many are not owned by banks. Nonbanks have become important providers of financial services, offering consumers not only ATM services but also home-banking software. The future effects of such technology on the commercial banking industry are not yet certain. It is possible that the industry will become less vertically integrated as banks contract out for more services, but large and small banks are likely to react differently. Industry regulators also face new challenges with technological change, Kamihachi said. Keeping tabs on the financial system will require that regulatory agencies hire staff who understand all the changes. And, regulators must be able to understand the new quantitative models developed by the financial industry to assess risk.

Financial Services Competition and Regulation

This session was moderated by **Jeffrey Kutler,** executive editor of American Banker. Participants were **Edward J. Kane,** James F. Cleary Professor in Finance at Boston College; **Bernard Shull,** professor of economics at Hunter College; and **William A. Ryback,** associate director of international supervision at the Board of Governors of the Federal Reserve System. They discussed the effects of new information technologies, mergers, and globalization on competition and regulation.

Kane pointed out that while we think of banks as financial service providers, they are really information providers. They gather, verify, analyze, store, and transmit financial data. And this process is often far more important than the actual transfer of money. An information exchange occurs well before contracts are signed and money is exchanged. In this information role, banks find themselves in competition with nonbank information providers such as phone companies. The number of competitors is likely to increase as the information industry grows. Not only the financial services industry but also regulators face the challenge of keeping up with the fast-moving technology that drives this competition.

Mergers are another factor affecting the financial structure and they also raise questions regarding monopolies, Shull said. In recent years the federal government has approved a large number of mergers, greatly reducing the overall number of commercial banks. Perhaps it is time for the government to rethink its merger policy, but this requires rethinking the definition of a market in financial services. If the goal of merger policy is to prevent monopolies within markets, then what constitutes a market must be clear, and this is no longer so.

Globalization is also bringing change and often in ways that make it difficult for regulators to keep tabs on the financial services industry, Ryback said. Information is flowing across so many boundaries and through so many channels that regulators often have a difficult time tapping into the flow. Sometimes they are denied access outright. For example, banks often contract out for services such as data processing and internal audits. But if they contract with a company in another nation, U.S. regulators often cannot gain access to the information gathered by those contractors, especially if they are operating in nations with secrecy laws.

Charles Freedman

Freedman presented an overview of the Canadian banking system, which he said has become much more open to competition. Twenty years ago Canada's financial services industry was segmented by type of business activity, but legislative changes over the years have made it possible for the segments to expand into one another's service areas. In addition to this internal competition, the Canadian system has become more open to foreign competition. As a result of these changes, Canadian banks have now become full-fledged conglomerates. Freedman said the changes are likely to continue and it is hard to predict what the Canadian financial sector will look like in two decades.

Recent Developments in International Banking

This session was moderated by **Philip F. Bartholomew,** director of the Bank Research Division at the Office of the Comptroller of the Currency, U.S. Department of the Treasury. Participants were **James R. Barth,** Lowder Eminent Scholar in Finance at Auburn University; **James Bothwell,** chief economist at the U.S. General Accounting Office; **Gillian Garcia,** senior economist at the International Monetary Fund; and **George G. Kaufman,** John J. Smith Jr. Professor of Finance and Economics at Loyola University.

Barth presented the results of a study of commercial banking structures and regulations in the 15 European Union countries, Canada, Japan, Switzerland, and the United States. The study found a wide range of banking structures and supervisory practices across the countries, with much of the variation due not to market forces but to differing laws and regulations. The United States and Japan have far more restrictive banking systems than the other nations in the study. Barth pointed out that the value of such a study is that it can provide alternative models for nations looking to reform their banking structures. But the multitude of structures also raises the question of how a future global system can be created from such variety.

Bothwell presented the findings of a study of the regulatory structures of five nations: Canada, France, Germany, Japan, and the United States. This study found that compared to the United States, the other nations have less complex and more streamlined oversight structures. They have fewer national agencies involved in regulation. Where there is more than one oversight agency, one is clearly responsible and accountable for consolidated oversight and a single set of rules, standards, or guidelines exists so that regulated institutions do not get mixed signals from different regulatory agencies.

Garcia shifted the discussion to include the developing world. She pointed out that the International Monetary Fund is taking a greater interest in banking structures because failed banking systems have powerful effects on macroeconomic policies. She presented results of a study of deposit insurance systems in 50 nations that aimed not only to develop a best model for the systems, but also to learn why systems fail. From the study a Òbest practicesÓ model was developed that suggested how nations ought to develop and operate a deposit insurance system. The study concluded that many countries' systems fail because they frequently violate these best practices.

Kaufman spoke on the role of state-owned or state- controlled banks in banking crises. State-owned banks are common in much of the world because governments can use them to pass on political favors to supporters and to raise revenue. When governments control or own banks, they will go to great lengths to protect them from collapse. This only encourages those banks to engage in hazardous practices, a leading cause of bank crises. Kaufman suggested that the banking systems in such countries could be made sounder by privatizing government banks, but many governments are reluctant to give up the benefits of bank ownership.

Laurence H. Meyer

Meyer moved the discussion from the international to the national level. He pointed out that often lost in the discussion regarding reform is the fact that much reform has already occurred during the past 20 years. He cautioned that while we must continue the process of modernization and reform, we must not be so eager for change that we move faster than is wise. The financial structure is undergoing rapid change due to advances in technology and innovations in organization and management. The challenge will be designing a system that moves with this change while maintaining the safety and soundness of the banking system.

Jack Metcalf

Metcalf gave an update on congressional actions regarding reform of the financial services system. He admitted that major reform is unlikely to occur during the current congressional session. While reform proposals have emerged, they have not gained wide support from the banking services industry or members of Congress. Reform is a difficult task for Congress, Metcalf said, because it is trying to balance change with safety. The financial services sector must be given the flexibility to change with the times in order to remain competitive in a global economy. Yet, many, and Metcalf included himself among this group, want to ensure that such changes will not be detrimental to consumers. Many consumers, government officials, and policymakers fear that reform might allow a few conglomerates to control the banking industry, but this fear should not stop Congress from addressing the issue of reform. "Unless we [Congress] act, the courts and regulators will."

Consumer Finance, Debt, and Risk Management

The session was moderated by **Douglas D. Evanoff,** senior financial economist and assistant vice president at the Federal Reserve Bank of Chicago. Participants were **David A. Levy,** vice chairman and director of forecasting of the Levy Institute, and **Karen Shaw Petrou,** president of ISD/Shaw, Inc. Both focused on consumer debt, Levy from the perspective of consumers and Shaw Petrou from that of lenders.

Consumer debt has greatly increased and this aggressive spending is the primary reason for the economy's strength, Levy said. Household debt as a percentage of disposable income is at a record-high 85 percent; those at the lower end of the income scale are most in debt. Levy attributes much of this increased spending to aggressive lending by banks and a strong stock market. Lower-income households appear to be borrowing to stay afloat. Middle-income households are using debt to enhance their standard of living. At the higher end of the income scale, stock market gains are encouraging households to increase spending. Levy warned that this aggressive spending cannot be sustained. Lenders are tightening credit standards, and if the stock market turns down, high-income households might decrease their spending. These two changes could reduce consumer spending and that will slow the economy.

But consumers who want to continue spending can still find willing lenders, Shaw Petrou said. The subprime lending market, which lends to high-risk clients, is very active. But it is a dangerous business that Shaw Petrou predicts will collapse. To turn a profit, subprime lenders must charge hefty fees up front and serve a large number of clients in hopes of roping in enough who will actually pay off their loan. But these clients are migrating to prime lenders because prime lenders are changing their methods for determining credit risk. They are finding that many potential clients once considered too risky due to mistakes in their past are not so risky after all. As a result, they are offering such people loans with lower fees and interest than those offered by subprime lenders. This leaves subprime lenders with only the riskiest of clients.

Federal Reserve Policy's Effects on the Efficiency and Stability of Financial Markets

The session featured **Peter E. Kretzmer,** vice president and senior economist at NationsBanc Capital Markets, Inc., and **Robert Glauber,** with the Center for Business and Government of the Kennedy School at Harvard University. The moderator was Levy Institute Senior Fellow **Walter M. Cadette.**

Since the 1980s the Federal Reserve has become quite adept at controlling inflation, Kretzmer said, and its success has gained the Fed much credibility within the financial services industry. This is a great improvement over Fed policy decades ago, when it was often incorrect and mistimed and served only to exacerbate bad situations. Despite this success, Kretzmer sees two dangers facing the Fed. First, there is much confusion about what its long-term goal ought to be. Perhaps it is time for it to consider goals other than low inflation. Second, there is a danger in the FedÕs continued belief in a long-run Phillips curve trade-off, according to which policy must chose between low inflation and low unemployment. "A central bank must distinguish between low unemployment that is sustainable and reflects good economic structure and low unemployment that is the temporary result of monetary ease. The two situations have vastly different implications."

One of the Federal Reserve's roles, Glauber said, should be as regulator of the financial services industry. The Fed needs to have some regulatory authority in order to manage monetary policy and that authority could become even more important as the financial services industry continues changing. Recent legislative and regulatory changes have opened the way for consolidations within the industry, mergers across industry lines, and expansion across state and national lines. These changes will make regulation of the financial services industry more difficult as government tries to sort out not only who should regulate, but also how to regulate this changing industry.

John D. Hawke Jr., undersecretary for domestic finance at the U.S. Department of the Treasury. Hawke addressed the issue of reform but requested that his comments be off the record.

Financial Services, Markets, and Public Policy

The session featured **Martin Mayer,** a guest scholar with The Brookings Institution; **Mark C. Brickell,** managing director of J.P. Morgan & Co. Incorporated; and **Paul A. Schosberg,** president of America's Community Bankers. Executive Director **Dimitri B. Papadimitriou** served as moderator.

Mayer focused on a little-known change in federal policy that will have important implications for the financial services industry. In an effort to save money, the federal government recently adopted legislation requiring that by January 1999 all federal agencies perform financial transactions by electronic mail rather than paper mail. For example, Social Security recipients are to receive payment by direct deposit rather than paper check. Government contractors and others doing business with the government are also to be paid by direct deposit. This change means these clients must have accounts with banks equipped to handle electronic transfers. Banks will have to move into the electronic era or lose customers, and clients who cannot afford a bank account may find it difficult to get payment from the government. Although many states require banks to offer low-fee basic checking accounts, federally chartered banks are under no such obligation, Mayer pointed out. The possible effects of this policy highlight the fact that government changes not explicitly directed at the financial services industry still have important impacts on that industry.

In speaking on regulation of derivatives, Brickell noted that dealing in derivatives has grown tremendously and is now a mainstream business practice. Much of that growth can be attributed to a successful regulatory system. The current regulatory environment, in which the derivatives business has prospered, is characterized by three important features: strong and clear laws, reliance on market discipline, and regulatory diversification. While there is still room for improvement in the regulation of derivatives, Brickell said, the derivatives regulatory framework might be a good model for regulatory reform of other activities within the U.S. financial system.

Schosberg closed the conference with a final call for reform of the financial structure and regulatory system now, before a crisis emerges. The savings and loan crisis showed that waiting until a crisis occurs is costly. But neither Congress nor the White House seems to have learned this lesson. Neither has a clear vision of where reform should go. Government and the financial services industry must seize the initiative and act because without a sound, strong banking industry the United States will find it difficult to maintain a dominant position in the global economy.

Transcripts of the speakers'remarks and more complete summaries of the sessions will be published in the conference proceedings. To order a copy of the proceedings, contact the Levy Institute as directed on the contents page.

The Levy *Report* Interview

Alicia H. Munnell Discusses the Future of Social Security, the Consumer Price Index, and Income Inequality in America

Alicia H. Munnell, member of the Council of Economic Advisers

Alicia H. Munnell is a member of the Council of Economic Advisers. Previously, she served as assistant secretary for economic policy at the Treasury Department and was a senior vice president and director of research at the Federal Reserve Bank of Boston. She is the author of numerous publications spanning a wide range of economic policy issues. On February 26, Munnell met with Assistant Director Sanjay Mongia in Washington, D.C., to discuss a number of important policy issues. Excerpts from their meeting follow.

Mongia: There is a lively discussion about the socioeconomic implications of the demographic shift related to the aging of America. What are your concerns about the current direction of the debate about privatization of Social Security?

Munnell: The Economic Report of the President this year contained a chapter on the aging of America and its implications for programs for the elderly. We focused on Social Security, on Medicare, and on the nursing home component of Medicaid. It's very important to recognize how crucial these programs have been for the well-being of older people in this economy. Social Security benefits have cut the poverty rate among the elderly from about 30 percent to around 10 percent in the past 30 years. Older Americans, before the introduction of Medicare in the late 1960s, lived in fear of having an illness for which they would not be able to get health care because they were not all able to get health insurance. The knowledge that their health care costs are, to a large extent, taken care of has improved both the emotional well-being and the health of older Americans. So these are very important programs.

Your question focuses on Social Security, and the Advisory Council on Social Security has just completed its report, in which it put forth three alternative proposals. One would keep the system pretty much as it is; one would cut back on benefits and then introduce a separate individual account of 1.6 percent of payroll on top of this reduced system; and one proposes a major restructuring of the system with a privatization scheme that was modeled after the Chilean system. The last proposal has enormous transition costs and would have an enormous impact on the budget.

When considering these alternatives, it is useful to have in mind the current status of Social Security. Social Security currently has a tax rate of 12.4 percent of payroll for old age survivors and disability insurance; the 75-year cost of these programs under the intermediate assumptions is 14.6 percent. Thus, the deficit in the 1996 Trustees Report was just a little more than 2 percent. I'm not endorsing a tax increase, but a 2 percent deficit means that raising taxes by 1 percent each on the employer and employee could solve the Social Security financing problem for the next 75 years. The financing gap should be closed in order to restore public confidence in the system; we should not allow people to think that the system is not capable of meeting its obligations. In reality, Social Security has enough to meet its obligations through 2029 with current taxes. Current taxes are also sufficient to pay 75 percent of benefits through the year 2070. Therefore, it's really a question of how we make up for that missing 20 percent to 25 percent after 2030. There are many options, and this administration has not endorsed a specific proposal at this time. We are in the process of reviewing the proposals put forth by the Advisory Council on Social Security.

Mongia: In the past you have opposed means testing of Social Security benefits for wealthier recipients. Is there any scenario that you can anticipate in which it may be fiscally necessary to means test benefits for wealthier Americans?

Munnell: The trick is to target benefits as much as possible so they go to the people who need them most and at the same time make benefits broad based enough to ensure widespread support for Social Security. The program has relied on a twofold approach to date. First, Social Security has a progressive benefit formula that provides disproportionately higher benefits for lower-income people than for higher-income people. Second, a major portion of Social Security benefits for upper-income individuals is included in the personal income tax base. These are two ways to target benefits, but they don't have explicit means-testing characteristics. Everybody feels entitled to get something out of the Social Security System, and this universal support for the program has made a very important contribution to its success over the years.

Mongia: Do you favor raising the retirement age beyond the statutory increase mandated under current law?

Munnell: I certainly understand the argument for raising the retirement age. Life expectancy at 65 has gone up enormously since the retirement age was first established in the late 1930s. There is compelling logic that we should spend some of those additional retirement years working. The argument against raising the retirement age is that there are people who, unlike you and me who do nonphysical work and can work well into our sixties, do physical labor and who may find it very hard to work past the current early retirement age of 62. We need to do some careful analysis; I asked the CEA staff to bring me the literature on what percent of people are capable of working in older age and what percent really have physical limitations, but I was very surprised to learn that we really do not have that information in a form that allows us to make useful decisions. It is important to have those answers before changing policy, and we need to have some provisions for people who, because of health or lack of employment opportunities, cannot work until age 67 or 68.

Mongia: Are you also concerned that raising the retirement age may have adverse employment effects for younger and future workers?

Munnell: We are entering a period during which the economy will experience very low or zero growth in the labor force, and the demand for older workers may increase naturally as the inflow of younger workers entering the workforce slows. In that sense, it may all work out well.

Mongia: Are you concerned that privatization of Social Security may actually be another step in the direction of privatizing broad areas of the social safety net and forcing individuals to create personal "rainy day" funds?

Munnell: Privatization proposals have received a lot of attention recently and certainly will be part of the reform debate, but a positive case can also be made for the current Social Security arrangements. We all start out our work life and we don't know what the future holds. Some of us start out more advantaged than others and have some sense whether we are going to be high income or low income, but we don't know for certain. We certainly don't know whether we're going to be disabled or whether a spouse is going to die. So, we pool our money as a cohort and contribute over our work lives to a system that will pass back to each of us some sum when we retire. That system also provides insurance against coming in on the low endÑa lifetime of low earnings. The system provides insurance against being disabled and not being able to work, and it offers insurance against the death of the family breadwinner, which may lead to the surviving spouse's not having enough money to go forth. In my view, the pooling of risk has greatly enhanced the economic security of millions of Americans.

Mongia: Do you believe, as has been suggested by the Boskin Commission, that the consumer price index overstates inflation, and if so, would you recommend a downward adjustment of the CPI as a corrective measure?

Munnell: The Boskin Commission has done a very useful exercise in trying to quantify an issue that economists have been concerned about for some time. The commission has come up with a specific number that is composed of several components. Some of the bias in the CPI reflects the ability of consumers to substitute one good for another. There is agreement among most economists on this point. Then, however, the Boskin Commission tries to quantify the bias due to quality changes, and that's a more controversial area. This administration's position has been that the consumer price index is a crucial number; it affects measures of real wages, measures of real GDP, Social Security benefits, and many provisions of the tax system. It's very important that we have a CPI that accurately reflects changes in the cost of living.

Mongia: Are you suggesting that the commission's report is simply a point of departure for the ensuing debate over the CPI?

Munnell: As I said, the CPI is an important number. We want it to be as accurate as possible.

We want it to be as accurate as possible for economic reasons because we need to measure aggregate output, and we need it to be as accurate as possible because it's used to index both the benefit side of the budget, for example, Social Security, and it's used to index various provisions of the tax system. The commitment on the benefit side is to have benefits keep pace with the changes in the cost of living. Much of this discussion focuses on how close the CPI is to a real measure of the cost of living. Economists have always argued that the CPI is an upper bound because it does not allow for substitution. As some prices increase, people can find substitutes, so they don't need quite the full amount of money that they would require if they were going to duplicate the initial basket of goods. The current CPI does not take account of substitution effects, and there lies the most agreement. Opinions diverge a lot more when it comes to the extent to which the CPI is overstated for quality reasons.

Mongia: Are you concerned that politicians may rely on the CPI as a type of magic bullet to balance the budget rather than take the more difficult tack of cutting spending and establishing priorities?

Munnell: This administration and nearly all economists believe that we have to aim for the most accurate measure of the cost of living for indexation. Any adjustments must be based on technical accuracy and not be budget driven. We have stated very clearly that we want the right number, and the process cannot be influenced by political considerations.

Mongia: Last year the Council of Economic Advisers reported that the majority of the several million new jobs created during this administration have been in sectors that pay above median wage. However, what can be done to reverse the rising tide of income and wealth inequality in the United States?

Munnell: The increase in inequality is a very disturbing trend that has been going on for 20 years. It is hard to come to a firm conclusion about exactly what may be the cause, but a host of factors could be contributing. The largest, in my view, is a shift toward increasingly high-technology industries and an increase in the demand for high-skilled workers. This shift has created a situation in which the returns to education have risen enormously since the late 1970s.

In terms of reversing the trend toward inequality, both short-run and long-run measures can play a role. The long-run measures, in my view, generally fall into the category of education, which President Clinton has made a priority. That means improving education and the ability to input knowledge at every stage in a person's life, plus making sure people have access to college and continuing education. That is the only way to increase human capital investment in people and allow them to compete effectively in the job market.

Mongia: Some observers have criticized the administration's education initiatives for devoting too many resources to the would-be winners in society.

Munnell: I don't think that's a fair criticism. President Clinton has put a lot of effort into expanding Head Start. The priority now is that every 8-year-old be able to read, and the administration has put a lot of emphasis on basic skills, which the president very firmly believes children must acquire as they pass through school systems. The administration is not focused on the winners; in fact, I think it's just the opposite. The administration's education efforts are really focused on the people who have not been able to benefit from the educational system today.

In the long run, investing in education and trying to ensure that each person functions up to the limit of his or her ability seems to me the absolute right answer to this problem of income inequality. The problem is that a large expansion in, say, Head Start is not going to produce benefits in the form of higher incomes for 18 years. These are long-term investments and one must be patient before seeing the payoff.

So what do we do right now for addressing the problem of increasing inequality? The administration has produced two main efforts. One is increasing the minimum wage, which Congress passed last year. The other provision, which is my particular favorite and one that has been supported by Republican and Democratic administrations over the years, is expanding the earned income tax credit. The EITC is sort of an economist's dream. We ask workers and their employers to negotiate and come to a settlement on the wage, and then the worker at the end of the year calculates his or her earnings, and, if eligible, the worker receives a refundable credit from the federal government for an additional amount of money to bring working families out of poverty.

Mongia: During your earlier remarks on education you said that there is a declining demand for low-skilled workers. The administration, however, has asked the private sector to join in a collaborative effort to facilitate the transition from welfare to work. What will be the effects of implementing the welfare-to-work initiative and adding nearly two million workers to the low-skill and low-wage end of the labor market?

Munnell: It will obviously increase the supply at the low end of the market. One way to minimize the impact of the increase is to make sure that anyone who doesn't have to be at the low end--for whom skill, additional training, or more education would be useful--gets out of that group. Moving as many people as possible up the skill ladder is the best way to counteract the excess supply problem. I just cannot emphasize strongly enough, however, the importance of a strong macroeconomic environment; a rapidly growing economy will make it so much easier to absorb workers.

Mongia: By emphasizing private sector employment for workers currently on welfare, are you concerned that the administration risks reinforcing the stigma against public sector work?

Munnell: You're talking to someone who has been a government bureaucrat her whole life, and I was proud to be a government bureaucrat for my 20 years in the Federal Reserve System. Given the quality of workers I have found at the federal level during my service in the administration over the past 4 years, I'm also proud to be a federal worker. So I don't think that there should be any stigma associated with being in public employment. We are relying on the private sector to help to facilitate the transition from welfare to work to avoid a public perception that we are simply moving people from one public program to another. The whole purpose behind the initiative is to get people off welfare and into mainstream life; since most people work in the private sector, mainstream might aptly refer to the private sector. The message is that welfare must be only a stopping point along the way that people may need to use. But it's only a slight sojourn on the way to full integration into the economic mainstream.

Debates-Debates

European Monetary Union

Levy Institute Distinguished Scholar Wynne Godley joined with five other panelists for a discussion of the proposed European Monetary Union on a recent segment of Debates-Debates, the nationwide television program. The question placed before panelists was "Is the European Monetary Union a nightmare to come?" Answering yes were Godley; **Eugene H. Rotberg,** member of the Levy Institute Board of Advisors and former vice president and treasurer of the World Bank; and author **Martin Mayer.** Supporters of the EMU were **Susan Dentzer,** chief economics correspondent with U.S. News & World Report; **Jeffrey E. Garten,** dean of the Yale School of Management; and Stanley Black, of the American Institute of Contemporary German Studies.

Although several panelists agreed that a monetary union could be good for Europe, they disagreed about the timing for such a union. Godley stressed that he is not against the monetary union, but believes it should not occur before political union. The danger of the EMU is that power will be shifted from democratic political structures to a powerful financial institution. "The question is whether what we give up is more important than what we gain," Godley said.

Panelists arguing in favor of the EMU disagreed that political union must come first. Garten said the EMU might actually help bring about political union. Once united in currency, European nations might unite in other ways as well. Dentzer and Black argued the EMU will strengthen the economy of each European nation and the stringent fiscal standards of the EMU will force each nation to keep its fiscal house in order. This will make all of Europe more competitive in the global economy.

Those fiscal controls are part of what worries both Mayer and Rotberg. Joining the EMU will deprive states of powers they might need to solve their economic problems. Rotberg called the EMU a straitjacket that fails to consider the economic, political, and cultural differences among the European nations.

Trade Sanctions and Human Rights

In addition to the debate on the EMU, the Levy Institute sponsored a segment on the issue of trade and human rights. Panelists addressed the question "Is it still possible to impose trade sanctions to pressure human rights changes?" Arguing that sanctions can be used were **Robert Kuttner,** co-editor of The American Prospect; **Representative Maurice D. Hinchey** (D-N.Y.); and **William Greider,** author and national editor of Rolling Stone. On the other side were **Eugene Rotberg;** Greg Mastel, vice president for policy planning and administration at the Economic Strategy Institute; and **Jagdish Bhagwati,** professor of economics and political science at Columbia University.

Supporters of policies that link trade with human rights argued that such policies are justified not only on moral grounds, but also on economic grounds. The United States should not turn its back on suffering in other nations, especially if it can use its trade power to force foreign governments to improve human rights. In addition, Hinchey argued, it is difficult for U.S. industries to compete in global markets with industries that cut labor costs through the use of child or slave labor.

Panelists against the use of trade policy to promote human rights agreed that human rights ought to be a goal of U.S. policy, but argued trade policy is not the means to achieve that goal. Sanctions are rarely imposed against the biggest human rights abusers, such as China, because the United States fears losing trade with those nations. And when sanctions are used, those most hurt are U.S. exporters, who must watch from the sidelines as their former markets are grabbed up by competitors.

Seminar

Leonard Nakamura Raises Questions about the CPI

For the past 20 years the U.S. economy has been humming along far better than many believe, argued Leonard Nakamura during a March presentation at Blithewood. Nakamura, an economic adviser in the Research Department of the Federal Reserve Bank of Philadelphia, presented evidence that what appears to be a slowdown after 1974 is really the result of mismeasurement of the consumer price index. "Essentially, productivity has probably grown faster over the last 20 years than it ever has," Nakamura said. "There's something wildly wrong with our statistics."

And what is wrong is the data used to measure the CPI. Just how far off the index might be becomes evident when one matches CPI data against other price statistics, such as average price data. Comparing specific items, Nakamura found that in many cases the average price data showed prices rising far less than the CPI showed for the same items. The reason for this, he argued, is that the CPI does a poor job of dealing with sale prices. It acts as if prices are fixed, but they are not; because of sales and discounts, prices on items fluctuate dramatically. For example, when measuring airline fares, the CPI tracks full-fare prices. According to the CPI, from 1978 to 1996 airfares rose annually by 8.75 percent. That figure is close to the 8.81 percent increase reported by the airline industry for full fares. However, restricted discount fares during that time period rose only 1.96 percent annually, and these fares were not considered by the CPI data. "And how many consumers pay full fare?" Nakamura asked. "Not many."

Even with adjustments for sale prices, solving the problem of price mismeasurement will not be easy, according to Nakamura, because it is not easy to measure increases in quality. In other words, if the price of an item increases, one must ask if the increase is due to inflation or to an improvement in quality. A price increase due to improved quality is not the same as one due to inflation. But even with this quality problem, price measurements could be improved if government made use of the large amount of data kept by business and industry. This data would provide a much more accurate picture of actual price increases and might even shed some light on the quality issue.

Editorial

On Bridges to the Twenty-first Century: Figuratively and Literally

by David Alan Aschauer
Visiting Scholar, The Jerome Levy Economics Institute

Bill Clinton came to the presidency in 1993 promising to reorient public spending from consumption to investment: to streamline the government bureaucracy to boost spending on tangible investments such as roads and airports and on intangible investments such as education, worker training, and research and development. The well-worn sound bite of the 1996 campaign-Clinton's desire to "build a bridge" to the twenty-first century-echoed his previous promises to the American public.

Yet, despite the words, despite the promises, public investment spending continues its long-term slide. According to projections for federal physical capital spending in the most recent budget documents, between 1995 and 2002 total public investment in nondefense capital--transportation, water treatment, water resources, hospitals, housing, and other public buildings--will be trimmed by more than 6 percent, from $51.1 billion to $47.9 billion. Some of the spending categories, such as housing, hospitals, and other buildings, have little direct impact on economic growth. Yet, for the most part, it is only for these categories that spending is projected to increase: federally assisted housing from $5.4 billion to $5.8 billion and hospitals from $1.3 billion to $1.4 billion. Consequently, public investment in "economic" capital--the basic public infrastructure supporting our economy-will be sliced by nearly 10 percent, from $41.7 billion to $38.0 billion.

Meanwhile, pressure on the existing infrastructure will increase. More workers will be riding the subway; more trucks will be on the road; more freight cars will be on the rails; more planes will be in the air-all putting pressure on the available public capital stock. Federal physical investment spending, expressed as a share of total output, will slide rapidly. Nondefense spending will fall by 23.0 percent, from nearly 0.7 percent of output to barely over 0.5 percent. Economic infrastructure spending will drop by more than 26.0 percent, from over 0.5 percent of output to 0.4 percent.

Research-my own and that of others-has shown that public infra-structure spending is a key determinant of long-term economic performance. To take one example, good roads and safe skies are just as important as trucks and planes to the commercial viability of a company like UPS or Federal Express. Recently, I have investigated the relationship between public capital and economic growth using data for the 48 contiguous U.S. states from 1970 to 1990. I have found that we have underfunded public capital and that, as a result, the actual public capital stock lies well below the growth-maximizing public capital stock. Economic growth increases until the public capital stock equals some 62.0 percent of the private capital stock of factories, warehouses, and equipment. Some states have accumulated more than the growth-maximizing amount and have suffered a decline in growth. However, the average public capital stock equals 45.0 percent of the private capital stock, so more public investment-wisely undertaken-can be expected to boost economic growth. Specifically, a 10.0 percent, permanent increase in public capital is estimated to result in an initial rise in economic growth of 1.3 percent per year and, over the long run, in a cumulative rise in output of 25.0 percent. These gains are reduced when account is taken of the financing of public capital investment by a combination of public debt (to pay for the initial outlay) and taxes (to cover ongoing depreciation). Even so, the gains are striking: an initial stimulus to economic growth of 0.4 percent per year and an ultimate lifting of living standards by 6.0 percent.

How can public capital funds be wisely invested? The research reveals growth effects of various categories of public capital, including core infrastructure and schools and hospitals, highways, and water and sewer systems. For example, a 10.0 percent increase in core infrastructure and in water and sewer systems boosts initial growth by 0.4 and 0.6 percent per year, respectively. The research also shows significant growth impacts across various regions of the United States. For instance, a 10.0 percent increase in public capital raises initial output growth by 1.5 percent per year in the Snowbelt (the Northeast and Midwest) and 1.2 percent per year in the Sunbelt (the South and West). The numbers suggest that the biggest growth effects appear to come from the urban infrastructure of water and sewer systems in the Snowbelt region of the country.

In past months the administration and the Republicans in Congress have come to agree to improve our human capital stock. For instance, a new emphasis has been placed on adequately funding education and, in the words of the budget documents, "the expansion of the education stock is projected to continue under this budget." Yet, during this decade growth in federally financed education capital has outstripped growth in federally financed physical capital by 70.0 percent. In 1997 the education capital stock is projected to expand by 3.0 percent-above the projected 2.3 percent rate of growth of the economy. At the same time, the physical capital stock will creep ahead by less than 2.0 percent-below the growth rate of the economy. What the country needs, however, is a more balanced commitment to our public capital needs-to build a literal, as well as a figurative, bridge to the twenty-first century.

New Working Papers

Disinflationary Monetary Policy and the Distribution of Income

Willem Thorbecke
Working Paper No. 185

When the Federal Reserve raises interest rates to reduce inflation, it also widens the income gap between rich and poor. In a study of the effects of the disinflationary policy pursued by the Federal Reserve from 1979 to 1982, Research Associate Willem Thorbecke found that contractionary monetary policy benefited bondholders at the expense of lower-income workers and small firms. Hardest hit were minority workers.

In explaining the link between monetary policy and income distribution, Thorbecke cites research indicating that an increase in interest rates aimed at reducing inflation makes it difficult for interest-sensitive industries to obtain capital to finance production. Two sectors that are interest sensitive, and therefore affected by contractionary policy, are construction and durable goods manufacturing. With access to credit curtailed, production in these two sectors slows and the workforce is reduced. Not all economic sectors experience decreased employment during times of contractionary monetary policy; the nondurable goods, government, transportation, and mining sectors are barely affected.

Workers in the construction and durable goods sectors who are not union members are more likely to lose their jobs as production decreases than those who are covered by union contracts. These nonunion workers are usually those receiving the lowest pay. Thus, the lowest-income workers are most hurt by a contractionary monetary policy. And these lowest-income workers tend to be minorities. During the period of Federal Reserve disinflationary policy, African-American unemployment increased 9.5 percent and Hispanic unemployment 7.1 percent, while white unemployment increased only 4.5 percent.

Along with construction and durable goods workers, people likely to lose jobs as a result of contractionary monetary policy are employees of small firms. Between 1979 and 1982 the earnings of small firms declined much more than those of large firms, and small firm earnings never recovered from the 1981-82 recession, as did those of large firms. Meanwhile, during this disinflationary period, the returns to bondholders soared. Long-term Treasury securities provided a total return in 1988 exceeding 40 percent--the highest return ever.

Considering that a widening gap between rich and poor could destabilize society, Thorbecke questions the wisdom of pursuing contractionary monetary policies when inflation is relatively low. The Federal Reserve should consider letting the economy and employment grow with the aim of helping lower-income workers.

Gender Wage Differentials, Affirmative Action, and Employment Growth on the Industry Level

Judith Fields and Edward N. Wolff
Working Paper No. 186

The fact that men and women often receive different wages for the same work is documented in much economic literature. But why this is so and how the gender wage gap can be closed are not clearly known. Research Associates Judith Fields and Edward N. Wolff believe they have found part of the answer. Their research indicates that three industry characteristics play an important role in explaining wage differentials: the likelihood that firms in an industry will be targets for affirmative action compliance review or investigation, the level of industry employment growth, and the level of industry profitability. For their study, they focused on the gender gap in industry wage premia--differences between male and female pay in an industry after netting out all of the wage differences that are associated with the productivity-related characteristics of the worker. The authors state that by using wage premia rather than earnings, they are better able to control for differences in male and female productivity.

Fields and Wolff's analysis indicates that industries frequently targeted for affirmative action review or investigation have, on average, a lower gender wage gap. This finding suggests that discrimination against female workers is part of the reason women receive lower wages than their male counterparts.

The authors found that women are most likely to narrow the gender wage gap in industries in which employment is growing. It appears that fast-growing industries offer women opportunities similar to those offered men. This finding could mean the occupational distributions of male and female workers are more similar in these industries than in slower-growing industries. Fast growth lowers barriers for women to entering jobs for which either efficiency or equity wage premia are more likely. Also, employment growth tends to narrow the gender wage gap in industries in which male and female workers are considered close substitutes.

The third industry characteristic that appears to play a key role in the gender wage gap is industry profitability. Fields and Wolff found that industries with a high profit rate tend to have a low gender wage gap. They suggest two possible reasons for this finding. The first is that industries with high profits have the ability to pay their female workers equitable wages and therefore do so. A second possibility is that some industries, especially those that are highly competitive, pay women equitable wages to encourage them to be more productive and stay on the job. The profit rate of these industries increases because of the greater effort on the part of female employees and reduced turnover.

Fields and Wolff conclude that affirmative action leads to a narrowing of the wage gap between men and women. Compliance reviews are likely to be most successful at narrowing the gap if aimed at fast-growing industries where increasing wages and opportunities for new women hires will have little negative effect on current male employees. Compliance reviews are also likely to reap greater benefits if aimed at high-profit industries. Such industries not only are more capable of paying women equitable wages, but also are more likely to do so if convinced it would help them attract and retain productive female employees.

Real Estate and the Capital Gains Debate

Michael Hudson and Kris Feder
Working Paper No. 187

Cutting the capital gains tax to spur new investment will not be successful because most capital gains are in real estate, according to Research Associates Michael Hudson and Kris Feder. Using data from the Department of Commerce, the Internal Revenue Service, and the Federal Reserve Board, the authors found that approximately two-thirds of the economy's capital gains are taken not in the stock market, but in real estate. Therefore, reducing the capital gains tax will not release a flood of money for investment. What it will do is reduce the already low effective tax rate of real estate investors. Under current tax regulations, real estate investors are able to avoid paying income taxes on most of their real estate cash flow; because of depreciation allowances in the tax code, much of the real estate industry's ordinary income is converted into capital gains. This leaves the capital gains tax as the only major federal tax on real estate income.

Reducing the capital gains tax will allow real estate investors to continue accruing wealth while paying even less in federal taxes, which will reduce federal revenues. And the economy will not gain from this decreased tax burden because real estate speculators will benefit more than investors in construction and renewal. Because the supply of land is set, a reduction in real estate taxes will not lead to an increased production of land. What can be produced are buildings. But rather than investing in new construction, many real estate investors prefer buying or swapping existing buildings that can be fully depreciated each time they are sold or exchanged. As buildings are resold at rising prices, investors are allowed to depreciate them again and again and write off capital consumption allowances against their income. This makes it appear that they are suffering an erosion of wealth, which reduces their tax liability.

If the goal of capital gains tax reduction is to spur investment, Hudson and Feder argue that a new accounting system must be developed that divides capital gains into two categories: capital gains from productive investments and those from unproductive investments, such as real estate speculation. A reduction in capital gains taxes on productive earnings can be beneficial, but real estate capital gains are rarely of this kind and currently represent a majority of all capital gains. If capital gains taxes are reduced, they should not be reduced for property or land. In addition, the generous depreciation allowances that allow real estate investors to convert their income into capital gains should be tightened. Buildings should be depreciated only once. Lowering the capital gains tax without addressing the issue of real estate capital gains will only reward real estate speculators and corporate raiders. At the same time, it will shift the tax burden onto those whose primary source of income is their labor-an income source easily taxed.

No Easy Answers: Comparative Labor Market Problems in the United States versus Europe

Rebecca M. Blank
Working Paper No. 188

In a study of labor markets in the United States and Europe, Rebecca M. Blank, professor of economics at Northwestern University and director of the Northwestern University/ University of Chicago Joint Center for Poverty Research, found that although the United States and Europe appear to have different labor market problems, they actually share the same problem. The United States has a low unemployment rate but much income inequality. Europe has high unemployment but less income inequality. Both of these situations are the result of changes in the global economy. What is different is the way the United States and Europe have responded to these changes.

The United States has a flexible labor market structure in which it is relatively easy for businesses to change their labor force and wage rates. Most European nations have a far more regulated labor system that makes it difficult for businesses to reduce wages and benefits. In both the United States and Europe global competition and changing technologies have reduced the demand for low-skill workers, but increased the demand for high-skill workers. U.S. businesses, operating under a flexible structure, have been able to shift with these changes. Higher-skill workers are given a greater share of wages and lower-skill workers a lesser share. The result is a widening income gap. European businesses, on the other hand, are unable to make such wage shifts. As a result, they respond to these economic changes through hiring and firing, which leads to higher unemployment rates.

There are other factors that can affect the impact that global economic changes have on labor. For example, nations with income redistribution programs tend to have less income inequality, which means the costs of these economic changes are spread throughout society. Macroeconomic and monetary policies also affect wage and unemployment rates. Still, Blank believes it is useful for researchers to focus less on what is different about the U.S. and European labor markets and more on what is similar. From her analysis of the American and European economies, Blank develops what she refers to as the "unified theory." This theory implies that there is a trade-off between wage inequality and high unemployment. If the theory is correct, it might be difficult for nations to develop policies that both reduce unemployment and close the income gap.

Blank concludes that there is no easy policy that will solve the problems faced by low-skill workers. Each country may need to take a different approach. However, those approaches should consist of some form of active labor policy such as job training and placement and some form of income redistribution. Failure to develop policies that will help those negatively affected by economic change will eventually harm society as a whole.

Levy Institute News

Reconceiving Liberalism, a New Book by Resident Scholar Oren M. Levin-Waldman

Liberalism, as a political philosophy, is greatly misunderstood by most Americans, says Resident Scholar Oren M. Levin-Waldman in his recently published book, Reconceiving Liberalism: Dilemmas of Contemporary Liberal Public Policy. Liberals are perceived by many to be self- centered individuals who place personal rights above family and community. This focus on one aspect of liberalism-the protection of individual rights-has led many to view it as a political philosophy that lacks moral vision and is out of touch with mainstream American values. Liberals appear to have lost sight of the obligations individuals owe to the community.

Levin-Waldman argues that this apparent divergence of liberal policy from mainstream values can be reconciled by reconsidering liberalism's other values. Through a reexamination of major political philosophers, especially John Locke, who have had a profound influence on American political culture, Levin-Waldman finds that liberalism does contain a moral vision that is consistent with the values of many Americans. Locke has traditionally been viewed as a proponent of individual rights and the minimalist state. But Levin-Waldman argues that Locke actually showed much concern for the interests of communities and sought to strike a balance between individual freedom and the needs and interests of the community. Liberalism, as conceived by Locke, actually justifies a positivist state to support strong and viable communities. This justification provides a whole new ethical basis for the design and implementation of public policy. It provides a connection between past, present, and future American cultural values. This is important because many of the criticisms of liberal public policy stem from the perception that it is disconnected from the past and bears no relationship to American values.

Levin-Waldman shows how this new view of liberalism relates to public policy through an evaluation of several policy areas: economic stabilization, welfare, and public-private partnerships. He develops a new methodology, which he terms issues-oriented policy analysis. This methodology relies less on cost-benefit analysis and more on a philosophical understanding of what best serves the community. Through this new methodology, which involves applying political theory to contemporary public policy problems, Levin-Waldman shows the connection between liberal public policy and the traditional American values.

Research on Alternative Plans for Financing Social Security

As the leading edge of baby boomers enters retirement, the Social Security system faces extraordinary financial pressure. Many citizens and policymakers fear the system will not be able to make good on past promises. A recently released report by the Advisory Council on Social Security laid out essentially two approaches to financing the system. One approach would keep the system much as it is, with relatively small adjustments in benefit and taxation levels. The other would privatize it, requiring individuals to invest a portion of their payroll taxes in individual retirement accounts.

In order to provide the information policymakers and citizens need to understand these alternative plans, Senior Fellow Walter M. Cadette is examining the possible effects of both plans on the economy, their potential benefits and risks, and their chances for success. Cadette points out that there are vast differences between the two alternatives: pay-as-you-go versus advanced funding; social risk versus personal risk; and defined benefit versus defined contribution. The research project is expected to be completed later this spring and will be summarized in the August Report.

Distinguished Scholar Hyman P. Minsky Remembered

Family, friends, and colleagues of Hyman P. Minsky gathered April 9 for a memorial service at the Bard College Chapel. Minsky, a Levy Institute distinguished scholar, died October 24, 1996, in Rhinebeck, New York, at the age of 77. During the service many shared their memories of Minsky, giving insight into the life of the man as father, friend, teacher, and scholar. His children, Alan and Diana, remembered him as a loving and supportive father who engaged them in dinner-time debates on all subjects from politics to baseball, always encouraging them to explore and expand their intellect. Former students remembered Minsky as a teacher who pushed them to move beyond the limits of conventional economic thinking. Colleagues recalled him as a fellow economist always willing to help them understand the errors of their thinking and as a brilliant scholar ever ready to challenge the intellectual establishment. And friends remembered him as a trusted adviser and courageous man who always thought of others, even at the end of his life.

Minsky was a leading scholar in the area of financial systems. In his work on debt and the economy, he developed what became known as the "Wall Street paradigm," which states that the accumulation of debt eventually curtails firms' investment, leading to financial retrenchment and recession. Minsky joined the Levy Institute in 1990 as a distinguished scholar and was a member of its Board of Advisors. He came to the Institute from Washington University in St. Louis, where he had taught since 1965. He had also taught at the Carnegie Institute of Technology, Harvard University, Brown University, the University of California at Berkeley, and Centro di Studi Economici Avanzati in Trieste, Italy. He earned his doctorate in economics from Harvard University in 1954.

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