



# Summary

Fall 2002

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LEVY INSTITUTE

# Summary

Fall 2002

Volume 11, Number 4

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The *Summary* is a quarterly publication of the Institute, intended to keep the academic community informed about the Institute's research. To accomplish this goal, it contains summaries of recent research publications and reports on other activities.

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## LETTER FROM THE PRESIDENT

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To our readers:

This issue begins with three working papers under the program on the distribution of income and wealth. Senior Scholar Joel Perlmann compares Mexican immigration today with immigration at the turn of the 20th century and shows that it is different in terms of size and duration. He therefore questions the theory of segmented assimilation, i.e., that immigrant children entering American society at the bottom may have more trouble improving their condition today than in the past.

Research Associate Yuval Elmelech of Bard College and Hsien-Hen Lu of the National Center for Children in Poverty and the Mailman School of Public Health of Columbia University extend racial and ethnic differentiation in gender inequality research by analyzing Asian, Native American, and four Hispanic minority populations. They find that gender differences vary substantially across racial and ethnic lines and recommend further inquiry into the mechanisms underlying the strong association between immigration and gender inequality.

Research Scholar Asena Caner and Senior Scholar Edward N. Wolff propose a poverty measure that considers household wealth together with income. A comparison of asset poverty rates to official poverty rates showed that the latter were significantly lower for nearly all groups and that asset poverty is two to four times as prevalent as income poverty. The authors found that government programs failed to encourage asset creation among the poor.

The program on financial markets and monetary policy begins with a working paper by Institute Professor of Economics Philip Arestis and Research Associate Malcolm Sawyer of the University of Leeds that analyzes the economics underpinning the “third way.” The authors find that the economic models are based on New Keynesianism and conclude that macropolicies in the Economic and Monetary Union are inadequate to deal with problems of unemployment and inflation. In another working paper, Biagio Bossone of the Banca d’Italia and the International Monetary Fund analyzes narrow banking and rejects its validity, concluding that it deprives the economy of key functions and diminishes the benefits of conventional banking.

A second working paper by Arestis and Sawyer investigates the theory behind the new approach to monetary policy and the channels through which changes in the interest rate affect policy goals. They find that interest rate changes have a relatively weak effect on inflation but a substantial effect on the level of investment, and recommend more research into the role of the stock of money, a subject that has vanished from the macroeconomic framework. A third working paper by Arestis and Sawyer studies the probable impact of the United Kingdom’s adoption of the euro. It concludes that adoption of the currency would lead to significant cuts in public expenditures or increases in taxation, on the order of 5 percent relative to current policies, and would adversely affect the British economy.

Two working papers are included under explorations in theory and empirical analysis. Arestis and Sawyer, with Andrew Brown of the University of Leeds, use critical realism, an analytical methodology, to explain the falling value of the euro. They conclude that this approach is inappropriate for the most abstract and fundamental levels of economic theory, where key propositions are formulated. A working paper by David J. Cooper and Research Associate James B. Rebitzer of the Weatherhead School of Management of Case Western Reserve University analyzes how competition among health maintenance organization (HMO) networks shapes the practice style of physicians and the welfare of patients. They find that the presence of absolute and relative practice norms among physicians prevents the occurrence of a “race to the bottom” in the quality of care, and they call for further research into the formation and operation of these practice norms.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*

## Program: Distribution of Income and Wealth

### **Polish and Italian Schooling Then, Mexican Schooling Now? U.S. Ethnic School Attainments across the Generations of the 20th Century**

JOEL PERLMANN

Working Paper No. 350, July 2002

[www.levy.org/docs/wrkpap/papers/350.html](http://www.levy.org/docs/wrkpap/papers/350.html)

The theory of segmented assimilation warns that children of immigrants entering American society at the bottom may have more trouble improving their conditions today than did comparable children in the past. Senior Scholar Joel Perlmann questions this theory, noting that socially constructed race divisions affected earlier immigrants, low-skill work today is not as scarce as is claimed, education may be adequate for upward mobility, and the inner-city appeal to lower-class, second-generation youth encountering blocked mobility is not new to minorities.

Extending his earlier work, Perlmann compares Mexican immigration today with immigration at the turn of the 20th century by using data from the Integrated Public Use Microdata Samples (IPUMS), for the period 1940 to 1970, and the Current Population Survey (CPS) by the U.S. Census Bureau, for the period 1998 to 2001. School attainments over time highlight the extent to which second generations overcome the handicaps of immigrant generations. Perlmann first compares the differences in mean educational attainments between native whites of native parentage (NWNP) and three particular groups of immigrants: Poles, Italians, and Mexicans. He then moves forward in time by one generation, to the birth cohort that is 30 years younger, and compares the differences in mean educational attainment between NWNP and corresponding second-generation groups. The ratio of these two differences signals the extent to which the educational gap in the immigrant generation remains in its children's generation.

In the early 20th century, when the population comprised huge second-generation groups of Italians and Poles and smaller but significant numbers of second-generation Mexicans (U.S.-born individuals reporting both parents born in Mexico), the ethnic disadvantage was strikingly greater for Mexicans in every cohort and for both sexes (a pattern resembling that seen for blacks). The large difference in educational attainment can be attributed to the relatively lower educational attainment of their immigrant parents and their concentration in the rural Southwest, where secondary school expansion was slow and discrimination was distinctly institutionalized (along the lines of the systematic discrimination suffered by Southern blacks). For Mexicans, as for blacks, a far higher proportion of the gap remains across generations, compared to that seen in European immigrants in the first half of the 20th century. Among those born after World War II, Mexican Americans seem to be erasing more of the handicap suffered by their parents, but the most recent cohorts lag further behind NWNP than comparable European groups. This disparity, says Perlmann, is a cause for concern.

By explicitly linking education and earnings from the two data sets, Perlmann finds that second-generation Mexicans earn much more than recent Mexican immigrants with comparable levels of schooling and earn similar amounts as American blacks, but lag well behind the earnings of NWNP. Moreover, the data on Mexican work patterns do not compare with those on the inner-city black "underclass." Despite the thin evidence from CPS samples, which cannot explain the social and economic dynamics creating the Mexican-black differences, Perlmann expresses caution about using this evidence to support theories minimizing these differences. Additional findings show that Mexicans in the bottom two categories of schooling—high school dropouts and those receiving nothing more advanced than a high school diploma—are more likely to work full-time and to earn more

than black full-time workers. The same pattern emerges for native-born Mexican American men of mixed parentage. Moreover, young Mexican men are in more favored positions than blacks in every category. Preliminary evidence from the monthly CPS data suggests that the work and earnings patterns of economically vulnerable Mexican Americans differ in important ways from those of inner-city blacks to whom they have been compared in discussions of future prospects.

When the proportions of subjects who completed high school in the past (1896–1905 birth cohort) and who completed college recently (1966–1975 birth cohort) are juxtaposed, the gap between NWNP and second-generation groups is much larger today. This result, says Perlmann, should prompt concern and continued attention, regardless of data limitations and the role of sampling variability. By contrast, Mexican American women appear to be faring as well as, or even slightly better than, their earlier Polish and Italian peers, a finding that may reflect the pace of transformation in women's roles in society.

The early history of Mexican immigration, notes Perlmann, is different from the present in terms of size and duration. Moreover, immigration flows and the timing and proportion of subsequent second-generation Mexican Americans are very different from the comparable patterns for Polish and Italian Americans. It is therefore advantageous to avoid conflating the different historical trajectories of immigrant groups.

Perlmann disagrees with the Department of Education's annual survey that presents educational attainment data without distinguishing between native-born and foreign-born Hispanics. This practice, he asserts, neglects generational standing and the dynamics of immigrant groups in favor of race and ethnic origin, i.e., the education of "Mexicans" in the United States today is not the same as it was in 1920.

### **Race, Ethnicity, and the Gender-Poverty Gap**

YUVAL ELMELECH and HSIEN-HEN LU

Working Paper No. 351, August 2002

[www.levy.org/docs/wrkpap/papers/351.html](http://www.levy.org/docs/wrkpap/papers/351.html)

The "feminization of poverty" thesis, which holds that the ranks of the poor are increasingly composed of women and

their children, has been criticized for failing to recognize that minority women are disproportionately represented among the poor and for blurring the meaning of "feminization" in terms of measurement and interpretation. Using aggregate data from the Current Population Survey (CPS) for the period 1994 to 2001, Research Associate Yuval Elmelech of Bard College and Hsien-Hen Lu of the National Center for Children in Poverty and the Mailman School of Public Health of Columbia University, extend racial and ethnic differentiation in gender inequality research by analyzing Asian, Native American, and four Hispanic minority populations (Mexicans, Puerto Ricans, Cubans, and central and southern Hispanics). In addition, they assess labor market and family structure characteristics and immigration information using a standardization technique to estimate the extent to which socioeconomic and demographic composition shape the gender-poverty gap within and across racial and ethnic lines. Defined as a function of both income and family size and composition, poverty more adequately reflects the economic hardship faced by women relative to men.

In their documentation of the conjunction of racial/ethnic and gender characteristics in contemporary American society, the authors find that gender differences in human capital and labor force participation, and in educational and occupational attainment, vary substantially across racial and ethnic lines. The main factor shaping the feminization of poverty since 1960 is the changing structure of the American family, e.g., the breakup of the two-parent family. Other factors determining single motherhood and fertility rates vary by race and ethnic origin, and poverty rates of minority women surpass those of both white women and minority men.

Elmelech and Lu describe the gender-poverty gap in eight racial/ethnic groups, test the socioeconomic and demographic factors affecting variations in the gap using multivariate analysis (logistic regression), and employ a standardization technique to estimate the sources of the gap within and across racial and ethnic lines. Three sets of independent variables of special interest to the study are racial/ethnic origin, family structure, and human capital and labor market characteristics.

Drawing on the double disadvantage thesis—a more complex form of gender inequality, which occurs when a woman is also a minority group member—the authors propose two complementary hypotheses. The first is that the

gender gap in poverty rates is larger between minority men and women than between white men and women; the second is that the racial/ethnic gap in poverty rates is larger between white and minority women than between white and minority men. The data show that women (especially Hispanics of Puerto Rican origin) are more likely to be poor, that there is a substantial poverty gap across racial/ethnic lines, and that the gap is greatest in the Puerto Rican population and least in the Asian population. The poverty rates of Mexicans and Native Americans are relatively high, but are less distinguished by gender than are the rates in the white population, whose family units are relatively more stable. Black and Puerto Rican women are more likely to be poor than both their male counterparts and white women (the so-called double disadvantage).

Elmelech and Lu used logistic regression analyses predicting the likelihood of poverty among nonmarried men and women to measure the extent to which human capital, labor market, and demographic characteristics play a role in shaping gender poverty gaps. Controlling for age and immigration status, they found that gender does not increase the risk of being poor. However, family structure plays an important role in explaining gender inequality, while human capital and labor market attributes are important in shaping racial/ethnic inequality. They also found that gender variations in educational attainment and employment status play an important role in shaping the gender-poverty gap within Mexican and central and southern Hispanic groups. The full model, which added family structure and human capital characteristics to the baseline model, reiterated previous findings, namely, that blacks and Puerto Ricans were the two minority groups for which interaction between race/ethnicity and gender remained significant and negative (the double disadvantage).

Using a standardization technique, the authors found that 39 to 46 percent of the gender-poverty gap was explained by gender variation in employment status for most racial and ethnic groups (with the exception of Native Americans and blacks, who have relatively high labor-force participation rates). The dependency rate (number of children) played a much smaller role than the labor-force participation rate in determining the incidence of poverty in women. However, gender variations in marital status, single

motherhood, and number of children played a more crucial role for both black and Puerto Rican women, with each factor accounting for 7 to 10 percent of the gender-poverty gap. Marital composition played an important role among minority groups, with the exception of certain women (Asian, Cuban, and Mexican) with marriage patterns similar to white women. A surprisingly strong association was seen between immigration and gender equality, suggesting that immigration had an equalizing effect on gender poverty gaps, whereas assimilation may lead to greater gender inequality within racial and ethnic minorities.

The most consistent finding was that women are more likely than men of the same racial/ethnic origin to be poor, although white women are less likely than minority men to be poor. The white gender poverty gap is greater than that for Mexicans, Asians, Cubans, and Native Americans, while the widest gaps are found in the Puerto Rican and black populations. These findings indicate that gender and racial/ethnic origin have independent effects on economic hardship. Since employment plays a consistent role in determining gender inequality, variations in labor force participation rates are key to understanding the gender-poverty gap.

The authors' findings support the view that policies reducing the unemployment rate and boosting full-time employment among women could significantly narrow the gender-poverty gap, especially among whites, Hispanics, and Asians. However, black women's relatively high levels of employment and educational attainment are not sufficient to keep them from falling below the poverty line because many do not earn sufficient incomes to overcome the financial burden of raising children. In light of evidence that immigration status is more closely associated with economic hardship in men than in women, and that it plays a role in narrowing the gender-poverty gap, the authors recommend further inquiry into the mechanisms underlying the strong association between immigration and gender inequality.

## **Asset Poverty in the United States, 1984–1999: Evidence from the Panel Study of Income Dynamics**

ASENA CANER and EDWARD N. WOLFF

Working Paper No. 356, September 2002

[www.levy.org/docs/wrkpap/papers/356.html](http://www.levy.org/docs/wrkpap/papers/356.html)

The official definition of poverty used by the U.S. Bureau of the Census since 1960 is based on the food requirements of the standard family, whereby pretax income is compared to a minimum standard and updated annually according to the Consumer Price Index (CPI). As a result of perceived flaws in the official definition, the National Academy of Science (NAS) proposed poverty thresholds based on the cost of food, clothing, and shelter, with a small allowance made for other expenses. Research Scholar Asena Caner and Senior Scholar Edward N. Wolff propose a poverty measure that considers household wealth together with income. Using the Panel Study of Income Dynamics (PSID) database, they estimate the size and severity of asset poverty in the United States for various demographic and labor market groups.

The authors discuss alternate ways of setting poverty thresholds, outline concepts about the impact of adding net worth to the definition of poverty, and summarize the main findings of poverty duration analyses. Their literature review suggests that poverty measures including wealth in the definition of family resources are preferable to income-only measures. The authors also examine the persistence of poverty by identifying those who are chronically poor.

Asset poverty is defined by the condition of a family (two adults and two children) whose access to wealth-type resources is insufficient to meet their basic needs (\$4,000 in 1997 dollars) for a limited period of time (three months). Caner and Wolff use four alternative wealth measures—net worth (NW), net worth minus home equity (NW-HE), liquid wealth (LIQ), and asset holdings of \$5,000—and adjust the threshold for different family sizes and structures. Asset poverty is then estimated using the headcount index (the share of households unable to survive for three months if forced to liquidate all their wealth and consume the proceeds) and the poverty gap ratio (the amount of wealth required to bring the average asset-poor household to the asset poverty line).

According to the NW measure, a significant portion of the U.S. population—25 percent of all households—is in asset poverty, compared to the official income-based poverty rate of 13 percent. Excluding home equity increases the rate to 40 percent. About half of U.S. households have less than \$5,000 in liquid assets and are unprotected against adverse shocks. The study also finds that the rate of persistence of asset poverty is very high. There is a 60 percent probability that poor households will remain poor in five years. Despite high economic growth in the 1990s, a higher proportion were in NW poverty in 1999 than in 1984, and indebtedness increased for the poorest 10 percent of Americans.

The study shows that home equity is the most widely held asset category and an important part of household wealth. There was a noticeable increase in the indebtedness of asset-poor households from the 1980s to the 1990s, as both average mortgage and nonmortgage debt rose substantially and exceeded average asset holdings for the NW-poor households. However, the data indicate that buying a home has a highly significant positive effect on the transition out of poverty for all study samples.

Asset poverty rates in 1999 show striking differences among racial/ethnic groups (e.g., blacks were more than twice as likely to be asset poor than whites) and reveal that poverty indices decrease as household age and education levels increase, homeowners are much wealthier than renters, and female-headed families with children have the highest rate of asset poverty. There was no evidence that the black-white gap had narrowed over the study period, and no substantial change was noted in overall asset poverty rates, in spite of such compositional changes as immigration and aging.

The authors disaggregated the total change in NW poverty into two components: changes in the shares of population groups and changes in the NW poverty rates of these groups. This decomposition was made separately for racial/ethnic status, age, education, homeownership, and family type. They found that changes in age, education, and homeownership had some effect, but increases in poverty rates within certain subgroups kept overall poverty rates fairly constant.

When asset poverty rates derived from the Survey of Consumer Finances (SCF) wealth data collected by the Federal Reserve Board were compared with the PSID

database, the NW poverty rate rose 3.1 percentage points, the NW-HE poverty rate showed no change, and the LIQ rate climbed markedly—by 6.5 percentage points—compared to a net decline of 0.5 percentage points, a decline of 1.5 percentage points, and no change, respectively. Results also differed according to demographic characteristics. The authors suggest that the SCF data offer better estimates of household wealth since the survey asks more questions on asset and debt holdings, while the PSID oversamples the poor and may give a more accurate assessment of the wealth holdings of low-income households.

Comparing the asset poverty rates using PSID data to the official poverty rates published by the U.S. Bureau of the Census shows that the official poverty rates are significantly lower for nearly all groups. On average, asset poverty is two to four times as prevalent as income poverty. Although group rankings remain the same, the disparity in income poverty rates is greater than in asset poverty rates. As expected, the official poverty rate follows the business cycle, decreasing in booms and increasing in recessions, but net worth poverty appears to move in the opposite direction, suggesting that saving rates go down during booms and offset increases in asset prices.

In terms of asset holdings, the authors examine the portfolios of selected income- or asset-poor groups, disaggregate net worth into its component parts, and compute each component's share of the total net worth of the sample. Homeownership increased from 60 percent to 67 percent during the period, and mortgage holdings followed the same trend. However, their wealth shares moved in different directions, as mortgage debt as a share of house value climbed from 27 percent to 37 percent, after peaking at 40 percent in 1994. This result is consistent with the observation that the rising indebtedness of the middle class is due to rising mortgage debt and may be a result of changing incentives (e.g., home equity loans). The sharp rise in equity ownership (from 9 percent to 20 percent) is significantly skewed by wealth and income class, so home equity remains the major item in the portfolio of most households.

A probit model was used for each survey year to analyze all four measures of asset poverty and trace the independent effect of each factor on assets. The main results are that race/ethnicity is an important factor, households headed

by someone older than 61 are less likely to belong to the asset-poor group, and higher education levels increase the likelihood of greater wealth. Nonelderly couples with children, female-headed families with children, and single or widowed elderly people are more likely to be asset poor. Perhaps surprisingly, being black, married with children, or female with children diminished over time as a determinant of asset poverty.

Given the importance of household wealth and its concentration in a small segment of the population, Caner and Wolff recommend that poverty measures include wealth in order to better understand living standards in the United States. They show that a combined income-and-net-worth poverty measure in which the annuity value of wealth (paid out like a bond coupon) is added to household income (as defined in the Current Population Survey), so that the capital value of net worth remains the same, reduces the poverty rate by up to 50 percent for some groups, such as the elderly, college graduates, and homeowners. However, there is no substantial reduction in the overall poverty rate, signaling a low level of wealth among low-income groups.

An innovation of the study is its investigation of the correlation between asset poverty transitions with major lifetime events (e.g., divorce, illness, inheritance, starting a new business). The phenomenon of escaping asset poverty through marriage has increased over time, while getting divorced increases the chances of becoming poor.

Economic and financial developments benefited only a relatively small part of the U.S. population from 1984 to 1999. Asset poverty rates did not decline, even in the long expansionary period of the late 1990s. Although government programs may have helped many families in various ways, they did not make the poor more self-sufficient, owing to their short-term focus and failure to encourage asset creation among the poor. Therefore, new programs, such as Individual Development Accounts, introduced in 1998, should provide incentives for the poor to accumulate assets.



### The “Third Way” and the Challenges to Economic and Monetary Union Macropolicies

PHILIP ARESTIS and MALCOLM SAWYER

Working Paper No. 345, May 2002

[www.levy.org/docs/wrkpap/papers/345.html](http://www.levy.org/docs/wrkpap/papers/345.html)

The “Third Way” refers to the new political position that seeks to break away from traditional reformist socialism and neo-liberalism. It reflects a political debate that strives to renew the concept of social democracy (and to apply left-of-center values) while confronting the extraordinary changes transforming the world, such as globalization, scientific and technological innovation, and shifting customs and traditions.

Institute Professor of Economics Philip Arestis and Research Associate Malcolm Sawyer of the University of Leeds analyze the economics underpinning the Third Way in light of government policies, and find that the current Labour government in the United Kingdom and the economic model of the Economic and Monetary Union (EMU) are based on New Keynesianism. They conclude that the EMU’s macropolicies are inadequate to deal with problems of unemployment and inflation, and they propose alternative policies and institutional arrangements.

Governments follow the Third Way when their policies emphasize the nonaccelerating inflation rate of unemployment (NAIRU), neglect aggregate demand and fiscal policy, elevate monetary policy, raise concern over the credibility of economic policies, and adopt the assumption of rational expectations. Arestis and Sawyer outline eight elements that underlie the Third Way and validate its economics as a New Keynesian variety:

- (1) The market economy is considered to be essentially stable but may be destabilized by macroeconomic policy (particularly discretionary fiscal policy).
- (2) Monetary policy can be used to meet the objective of low inflation rates.
- (3) Economic activity fluctuates around the NAIRU, and unemployment below (above) the NAIRU leads to higher (lower) inflation.
- (4) Say’s Law holds.

- (5) The market system involves conventional welfare economics (governments correct externalities through appropriate taxation, subsidies, and regulations).
- (6) Long-run growth in income per head depends on investment decisions rather than exogenous improvements in technology (and the public sector plays a significant role since human capital is particularly important).
- (7) Concern over inequality of outcomes is addressed through a progressive tax system, a redistributive social security system, or education and training.
- (8) Globalization (increasing international trade and foreign direct investment) is acceptable and eliminates the effectiveness of industrial and macroeconomic policy (except competition policy).

The authors outline the key theoretical features and policy implications of the EMU system in which monetary policy is determined by the European Central Bank (ECB) and fiscal policy is constrained by the Stability and Growth Pact (SGP); the ECB sets the key interest rate to influence monetary conditions and future inflation rates; unemployment fluctuates around the NAIRU; and fiscal policy is subordinate to monetary policy. They note the complete separation between the monetary (ECB) and fiscal authorities (national governments) and lack of coordination between monetary and fiscal policy. They observe that the ECB is the only effective federal economic institution, with only one policy instrument (the interest rate), and that the national central banks are responsible for regulatory matters.

Arestis and Sawyer outline five problems concerning ECB monetary policy: the slow timing of policy decisions; methods of operation that are confusing to the markets (as a result of secretiveness and a failure to communicate those methods); voting behavior by the Governing Council that may result in policymaking with a national bias; an uncertain M3 reference value for monetary growth (there is no mechanistic commitment to correct deviations in the short term) and a perhaps overly restrictive inflation target of 2 percent; and a dubious extent to which changes in the interest rate can actually control inflation.

The authors also express reservations about the efficacy of EMU monetary policy. They cite the “one-size-fits-all” policy, noting that a country cannot offset the undesirable effects of interest rates imposed by the ECB. They point out that the transmission mechanism and its effectiveness in responding to recession and controlling inflation is uncertain, given the limited knowledge of the euro area’s economy and the time lag associated with the impact of interest rates on expenditures. The authors also observe that monetary policy objectives should include growth and employment as well as inflation, and euro exchange rate changes are expected to have a small effect on the EMU economy.

Arestis and Sawyer review the core elements of the SGP (whose main requirement is that national budget deficits do not exceed 3 percent of GDP), institutional arrangements if the ratios of budget deficit to GDP and national debt to GDP are not met, and such experiences as the condemnation of Ireland for cutting taxes and raising public expenditures when output was above trend. The authors conclude that there is a general deflationary bias in the operation of the SGP. They also discern serious flaws in its management, as exemplified by the Council (ECOFIN) ignoring the European Commission’s recommendation to censure Germany and Portugal when their deficits approached the 3 percent ceiling. Such concerns raise questions about the governance of the euro area, the credibility of EMU institutions and fiscal discipline, and the EMU’s preference to fudge rather than adhere to its principles.

According to Arestis and Sawyer, obstacles to full employment in the eurozone include a lack of productive capacity in many regions, regional disparities in unemployment, and the need for differentiated policies (particularly fiscal) across countries, in light of the incomplete convergence of business cycles from country to country. Restoration of full employment, the authors conclude, will take much more than a level of aggregate demand. It will require the creation of sufficient capacity to support full employment and cause a substantial reduction in regional disparities. However, the eurozone lacks the policies and the power to address the unemployment issue, and interest rate policy is unlikely to cope with major inflationary pressures.

The authors outline four elements, in addition to high levels of aggregate demand, that would create high levels of

economic activity without inflationary pressures: institutional arrangements for collective wage determination and price setting, which are currently decentralized and fragmented and do not exist at the European Union (EU) level; a well-functioning real economy, which would raise the general level of productive capacity and direct it toward less prosperous regions; major changes in the operations of the ECB that would, for example, cause it to act as the lender of last resort, be more proactive about bank surveillance and supervision, and set interest rates that encourage growth and full employment while combating inflation; and a revamped European Investment Bank (EIB) to supplement the ECB, with the specific objective of enhancing investment activity (by providing finance for long-term investment) in regions with acute unemployment.

Arestis and Sawyer’s main proposals include the removal of political constraints on national budget positions, so that national governments can set appropriate fiscal policy; the evolution of a body charged with strengthening institutional arrangements that coordinate national monetary and fiscal policies; the creation of institutional arrangements that would direct the operation of EU fiscal policy and ensure that monetary authorities do not dominate economic policy-making; and the formation of a revamped EIB. The need for serious coordination of monetary and fiscal policies, they say, is paramount.

### **Should Banks Be Narrowed?**

BIAGIO BOSSONE

Working Paper No. 354, September 2002

[www.levy.org/docs/wrkpap/papers/354.html](http://www.levy.org/docs/wrkpap/papers/354.html)

The fundamental mismatch between demand deposit liabilities and risky loans used as collateral lies at the heart of potential banking crises. Narrow banking would specialize in deposit and payment activities, match liquid liabilities with risk-free assets, and be restricted from lending to the private sector, thus eliminating issuer default risk for the depositor (the 100 percent reserve banking principle). However, narrow banking has neither been adopted by any country, evaluated relative to contemporary banking theories, nor analyzed in terms of its potential effect on the economy.

Biagio Bossone, of the Banca d'Italia and the International Monetary Fund (IMF), reviews the pros and cons of narrow banking and ultimately rejects its validity on conceptual and empirical grounds, concluding that it deprives the economy of key functions and diminishes the benefits of conventional banking.

Narrow banking proposals resurfaced in the United States in the 1980s when financial crises called for a reassessment of the extant banking regulatory regime. These proposals differed in terms of the restrictions they placed on bank asset portfolios and institutional design. The functional segregation of banking from nonbanking activities (e.g., separate subsidiaries) was seen as an optimal regulatory response to the risks associated with financial deregulation and innovation and the increasing power of the banks.

Benefits cited in favor of narrow banking include minimization of bank liquidity and credit risks, continued confidence in the face of changing loan values, fully secure payments, and improvement in the central bank's ability to control the money supply. Its adoption would also lead to reductions in capital requirements, bank failures, and the need for safety nets and bank prudential regulations. Narrow banking would protect all depositors, reduce moral hazard, prevent expensive bank runs, and provide greater shock resiliency. An example of the potential attractiveness of narrow-bank deposits and transaction services is the increasing demand for mutual fund products.

Proponents of conventional banking suggest that narrow banking regulations would eliminate the social benefit of banking. Conventional banks can transform illiquid assets into liquid deposits and improve risk sharing (by using their stable deposit base to finance production technologies that increase output over time). Banks provide both lending and deposit services, offering the advantage of efficiency; maintain an important role as a reliable supplier of liquidity to the corporate sector, especially at times of securities market distress; and stand at the inception of the production cycle, creating money and allocating it to firms. Banks also often specialize in retail services and wholesale businesses, supplying money needed for these ventures. Narrow banking, on the other hand, would suppress these features, credit would become more scarce and costly, and the money creation process would return to the central bank, at the expense

of economic efficiency. Also, narrow banking would hamper the development of the nonbank financial sector.

What might be the impact of narrow banking on operational issues? Tying monetary services to government paper (high-quality assets) and public debt management (which in turn is tied to monetary and payment system objectives) and assigning these services to government might not be good policy, says Bossone. Fluctuations in the market value of government paper as a result of sovereign risk would affect some developing countries (whose governments have been known to inflict capital losses on public debt holders through inflation, repudiation, and manipulation of yields). Under these circumstances, narrow banks would have to operate with significant market and capital loss risk. Narrow banks do not eliminate the need for safety nets for nonbank intermediaries, since governments appear unwilling to forgo insuring bank deposits or extending insurance, as a result of public pressure. Another concern is the cost of breaking multifunctional banks into separate corporations and creating a sufficiently strong firewall between them.

Some observers contend that narrow banks should be able to offer depositors returns that are competitive with other low-risk investments. Others caution that such a step would lead to reduced size and income and increased unit operating expenses, resulting in depressed interest rates paid on deposits, followed by an outflow of funds to nonbanks. Opponents of narrow banks also worry about scarcer and costlier credit for smaller borrowers.

Using data from the IMF International Financial Statistics for 46 countries across various time periods between 1966 and 2000, Bossone estimates the impact of bank narrowness on the private sector. The liquidity-to-asset ratio of the domestic banking sector serves as a proxy, and liquidity includes total claims on the central bank and government bonds held by the banks. The results show that bank narrowness has a positive effect on lending costs to the private sector and a negative effect on bank credit. Contrary to advocates of narrow banking who argue that credit restrictions would be dynamically offset by alternative supplies of funds, Bossone finds that this was not the case for either developed or developing countries. On average, a 1 percent increase in bank narrowness reduces the availability of credit to the private sector by 0.73 percent.

Bossone concludes that narrow banking would exact heavy costs in terms of efficiency and credit availability while delivering uncertain benefits in terms of greater financial stability. It would sever the link between liquidity, money, credit, and economic activity and would be particularly costly for developing countries. Therefore, propositions advocating narrow banking should be resisted. However, notes the author, nothing should impede institutions from offering narrow-banking services on a voluntary basis, or from creating subsidiaries within the same bank-holding companies.

In Bossone's view, an alternative to narrow banking is the "core banking" model, whereby functions are limited to activities in which banks have a comparative advantage and make the bulk of their profits. Another alternative is for regulatory regimes to separate commercial (short-term) banking from investment (long-term) banking. Also, a free-choice regulatory solution would allow financial institutions and customers to opt for either conventional or narrow banking instruments. Two options that would spur competition and strengthen market discipline without suppressing the benefits of conventional banking are (1) banks' issuing uninsured deposits bearing an option clause so that they could suspend deposit convertibility while liquidating assets in an orderly fashion, and (2) banks' issuing uninsured subordinated debt, which would signal their relative riskiness.

### **Can Monetary Policy Affect the Real Economy?**

PHILIP ARESTIS and MALCOLM SAWYER

Working Paper No. 355, September 2002

[www.levy.org/docs/wrkpap/papers/355.html](http://www.levy.org/docs/wrkpap/papers/355.html)

Current monetary policy is identified with interest rate policy—the interest rate set by the central bank influences aggregate demand, which in turn influences the inflation rate. A higher (lower) interest rate lowers (raises) aggregate demand, which affects the inflation rate and, in the long run, achieves the target inflation rate. This type of monetary policy is seen as a flexible and powerful instrument to achieve medium-term stabilization objectives because it can be adjusted quickly in response to macroeconomic developments, which fiscal policy cannot. Institute Professor of Economics

Philip Arestis and Research Associate Malcolm Sawyer of the University of Leeds characterize this approach as a new form of monetary policy that has emerged over the past decade, and maintain that it can only address demand inflation.

The authors investigate two issues: the theory behind the new approach to monetary policy and the channels through which changes in the interest rate affect policy goals. The underlying propositions are that even moderate rates of inflation are harmful to economic efficiency and growth, and that monetary policy is the only policy available to control inflation. The new approach emerged as an alternative to both discretion and monetary rule. Attaining a low inflation rate becomes the target and goal at the same time. The absence of an intermediate target provides the central bank with discretion to react to changing economic conditions without abandoning the commitment to reduce inflation. Since transparency and credibility are valued features of economic policy aimed at avoiding problems associated with time inconsistency, this situation has led to central bank independence. However, the authors note that because the chain of effects resulting from a change in the central bank discount rate to the target inflation rate is uncertain, it is important to consider empirical estimates of the impact of this new form of monetary policy.

Arestis and Sawyer develop a simple macroeconomic model, with three equations and three unknowns (output, interest rate, and inflation), that summarizes the underlying theoretical and empirical notions of the new monetary policy (but masks the many channels through which monetary policy operates). The mechanism targeting inflation is assumed to take place in the equations in which interest rates affect aggregate demand and changes in the inflation rate depend on aggregate demand. Since monetary policy is seen to work via the exchange rate in empirical models, the authors focus on open economies. The stock of money is seen to adjust to price levels, rather than the other way around. The authors note that their model refers to a single interest rate, and that the effect of the central bank's interest rate on long-term rates and the channels through which monetary policy are transmitted are uncertain.

Arestis and Sawyer investigate the theory and the empirical evidence relating to six channels of monetary policy. These include four traditional channels (interest rate, wealth

effect, exchange rate, and monetarist) and two more recent, credit-based channels (narrow credit, which focuses on the role of banks as lenders, and broad credit, which focuses on the financial health of borrowers). The two credit channels are instruments through which imperfections in financial markets affect the economy, i.e., how financial positions of lenders and borrowers affect aggregate demand, assuming credit market frictions. The wealth effect channel assumes that the consumption function depends on consumer wealth, i.e., policy-induced interest rates affect asset prices, the real value of consumer wealth, and consumer expenditures. The interest rate and monetarist channels are affected by the degree of substitution between money and other assets; if it is high, changes in the money supply will significantly affect interest rates and components of aggregate demand. In addition, the monetarist channel works through relative asset price changes, which impact aggregate demand. The exchange rate channel links monetary policy to inflation via total demand and import prices. Since the overall response of the economy to changes in monetary policy incorporates the combined effects of all channels, it is difficult, say the authors, to assess the strength and contribution of individual channels to the overall impact of monetary policy on the inflation rate.

The claim that monetary policy is an effective and powerful tool for macroeconomic management depends on a range of assumptions, including that variations in the interest rate have substantial effects on aggregate demand and, therefore, on the inflation rate. However, the relationship between the exchange rate and the interest rate (the interest rate parity approach) suggests that there are constraints on the degree to which domestic interest rates can address domestic levels of aggregate demand and inflation.

Empirical results from the eurozone, the United States, and the United Kingdom point to a relatively weak effect of interest rate changes on inflation. For example, according to national central bank models, a one-percentage-point rise in short-term interest rates has a maximum aggregate effect on output of -0.4 percent after two years and of -0.4 percent on prices after four years. In most models, prices react more slowly, and largely in response to changes in economic activity.

Simulations undertaken by the Bank of England show that the maximum effect of a temporary interest rate increase

on real activity occurs after about one year, while the maximum effect on inflation occurs after about two years. Other studies show that the exchange rate channel dominates in the first two years in terms of output and prices, and has the most effect on the inflation rate, while the user cost of capital channel dominates after the third year. In aggregate, the inflation rate is not permanently affected, and has returned to the benchmark level by year 5. Although empirical studies have shown that interest rate changes have a small effect on the inflation rate, such changes have a substantial effect on the level of investment.

Other studies demonstrate that the impact of a change in short-term interest rates on a range of economic variables is similar in the United States and the eurozone, but the effect on investment appears to be more muted in the United States. In addition, eurozone countries differ substantially in such matters as investment responses to changes in interest rates; such differences are relevant in light of the eurozone's adoption of a single monetary policy.

The main conclusions drawn from the survey of empirical evidence are that there are constraints to a permanent change in the interest rate, and the effect of interest rates on aggregate demand occurs as a result of substantial changes in the rate of investment (interest rate variations have long-lasting effects on investment, leading to changes in the size of the capital stock). These results do not conform with the theoretical basis of the new form of monetary policy.

The authors call for more research into the role of the stock of money, as the new approach to monetary policy has caused it to vanish from the macroeconomic framework. They also note that the new framework could lead to undesirable outcomes, e.g., excessive output volatility due to inflation targeting.

## **The Euro, Public Expenditure, and Taxation**

PHILIP ARESTIS and MALCOLM SAWYER

Working Paper No. 357, September 2002

[www.levy.org/docs/wrkpap/papers/357.html](http://www.levy.org/docs/wrkpap/papers/357.html)

If the United Kingdom joined the Exchange Rate Mechanism (ERM) and adopted the euro as its unit of currency, what would be the consequences for public expenditures and

taxation? Institute Professor of Economics Philip Arestis and Research Associate Malcolm Sawyer of the University of Leeds compare the Maastricht Treaty, Stability and Growth Pact (SGP), and European Central Bank (ECB) with the British system and conclude that replacing the sterling with the euro would lead to significant cuts in public expenditures or increases in taxation on the order of 5 percent relative to current policies. These deflationary measures would adversely affect the British economy.

According to Arestis and Sawyer, the Maastricht Treaty is deflationary because European Union (EU) countries cut budget deficits or reduce public debt to meet its convergence criteria. These criteria relate to such nominal values as inflation rates, interest rates, and budget deficits. In addition, countries raise taxes and reduce inflation without considering unemployment. The authors note that there has been no real convergence of economic growth, unemployment levels, national income per capita, and business cycles, and massive differences remain in living standards and unemployment rates across the EU.

At the present time, the United Kingdom satisfies all the convergence criteria except the criterion stipulating that the average exchange rate of a country's currency should not deviate from the central rate by more than 2.25 percent for at least two years prior to membership. Arestis and Sawyer believe that entry into the ERM would require the sterling to depreciate substantially (by 10 to 15 percent) and prices to fall relative to the rest of the EU. In light of similar historical episodes, the British economy would experience significant damage, so budget deficits would tend to rise and run into barriers erected by the SGP.

Under the SGP, budget deficits must be within 3 percent of gross domestic product (GDP) and members must keep their budgets close to balance or in surplus in the medium term. This rule has implications for public expenditure, since this restriction on automatic stabilizers could lead to weaker fiscal stabilization and greater output volatility. The major difference between the Maastricht convergence criteria and the SGP is that the 3 percent budget deficit rule applies to one point in time, versus any time throughout the business cycle. Recognizing that the EU budget is small, required to be in balance, and dominated by the Common Agricultural Policy (CAP), the authors conclude that there is little role for fiscal

transfers from relatively rich to poor countries, nor any possibility that the budget could operate as an automatic stabilizer.

The authors cite a number of examples in 2001 in which the SGP affected public expenditures with a general deflationary bias. The SGP criticized Irish budgetary policy on the grounds that its tax reduction measures were procyclical, thereby potentially aggravating inflationary pressures and widening the positive output gap. It recommended that the British government (which is not formally governed by the SGP) reduce public expenditures and maintain the public-expenditure-to-GDP ratio in the event of an economic downturn in 2002. In light of the ECB response to an Italian request to delay target dates for a balanced budget, as a result of an ECB-projected economic downturn, the ECB would likely raise interest rates in accordance with any increase in budget deficits. The EU finance ministers opted not to punish Germany and Portugal when they projected budget deficits close to the rule, reinforcing the notion that Europe puts political expediency ahead of good economic sense. Therefore, say the authors, the SGP was designed to punish any national government that attempts to reflate its economy, or whose regional or local governments increase their budget deficits, when ECB monetary policy dictates otherwise.

The euro operates within an institutional policy framework with three key elements relating directly to monetary and financial policy: (1) the ECB is the only effective federal economic institution, and has one policy instrument (the interest rate) with which to pursue low (0 to 2 percent) inflation; (2) the ECB and the national central banks are linked into the European System of Central Banks (ESCB), and the national banks are responsible for regulatory matters; and (3) the ECB is intended to be independent of governments. The result is complete separation between the monetary and fiscal authorities and little coordination of monetary and fiscal policy.

According to Arestis and Sawyer, the ECB has three major shortcomings: its undemocratic and unrepresentative nature, its confusing operations, and its proclaimed objectives. They suggest that operations be changed in two significant ways—by broadening the membership of the board of directors and making directors accountable to the European Parliament—and that objectives be reformulated to include growth and

employment, along with price stability. The authors also call for more ECB transparency.

Current British government policies balance the budget between tax revenues and expenditures and allow borrowing to finance public investment (the “golden rule”). Planned capital expenditures of 2 percent of GDP imply an overall budget deficit of 2 percent, which would be acceptable within the terms of the Code for Fiscal Stability (a stable debt-to-national-income ratio), but not within the SGP. The “golden rule” and the code differ from SGP rules in two important respects: the “golden rule” does not have a clear upper limit on the size of the deficit during recession (as opposed to 3 percent), and the code can be readily changed by Parliament (as opposed to the force of law).

The present capitalized value of future expenditure commitments in Britain is over £76 billion and rising, compared

to gross debt of £380 billion. Compliance with the SGP, therefore, would involve some combination of significantly lower public expenditures and higher taxation.

Arestis and Sawyer regard the overall government debt limitation of 60 percent (one of the convergence criteria) to be deficient, since it refers to gross debt and makes no allowance for government assets; includes only government liabilities such as bonds and Treasury bills; and excludes government obligations on future payments as well as liabilities incurred under the Private Finance Initiative. In addition, the rule does not distinguish between local and foreign currency debt. Therefore, a government facing the debt rule constraint would be encouraged to opt for more private financial initiatives that, under the present system, would not add to debt.

## Explorations in Theory and Empirical Analysis

### Critical Realism and the Political Economy of the Euro

PHILIP ARESTIS, ANDREW BROWN, and MALCOLM SAWYER

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[www.levy.org/docs/wrkpap/papers/352.html](http://www.levy.org/docs/wrkpap/papers/352.html)

Critical realism, an analytical approach focusing on issues of method, is popular within radical political-economy and methodology circles. Using their research methodology to explain the falling value of the euro, Institute Professor of Economics Philip Arestis, Andrew Brown of the University of Leeds, and Research Associate Malcolm Sawyer of the University of Leeds argue that critical realism is partially applicable to concrete levels of analysis, but inappropriate for the most abstract and fundamental levels of economic theory, as illustrated by the propositions of Keynes, Kalecki, and Marx.

Some economists believe that formalism in economic and social theory, as exemplified by econometrics and mathematical modeling, should be rejected on critical realist grounds.

At the more abstract and fundamental levels, other economists argue that critical realism is wrong. Rather than hypothesizing some new entity or structure, analysis should focus, they say, on connections among existing practices, institutions, and structures.

The authors acknowledge that formalism is a tool (although not the main one) of economic and social theory, and that the debate over formalism has overlooked more pressing issues, such as the contribution of method to substantive economic theory and policy. They note that the key issues raised by critical realism are more general than those associated with formalism; these issues, they say, offer useful insights by emphasizing that real social structures not only exist, but mesh in complex but potentially identifiable ways. A key problem, however, is that specifics of the social “vision” advocated by critical realists are elusive. Whereas critical realism traditionally views a lack of methodological specificity as a virtue, it cannot offer social scientists methodological suggestions because few general precepts exist. For example, it offers little advice about choosing the premises for

retroduction (the process through which previously unknown social structures and mechanisms are hypothesized), whose role and nature are underexplored in the context of critical realism. The authors evaluate the critical-realistic method in terms of their euro project as represented in their book, *The Euro: Evolution and Prospects*.

Because the formation of the European Monetary Union (EMU) was a unique and major event, the future cannot be similar to the past. The euro's creation was the culmination of a long process of economic and political integration. The authors' analysis therefore had to take into account the political and institutional developments leading to the formation of the EMU, and had to be forward looking, as when considering the desirability of UK membership and alternative policy arrangements. These conditions required a theoretical Keynesian framework emphasizing the role of aggregate demand and the operation of the forces of cumulative causation. A review of history, the fiscal and monetary institutions surrounding the euro, money-demand functions within participating countries, and the impact of the euro enabled the authors to provide an empirically sound explanation for the fall in the value of the euro.

The euro project illustrates the apparent utility of critical realism at the more concrete level of abstraction (e.g., the falling external value of the euro), but the more fundamental features of the project did not readily lend themselves to critical-realist interpretation. The surprise with which most economists reacted to a declining euro fits closely with the critical-realist approach to the first stages of social scientific investigation, in that it initiated a search for the underlying causes of this puzzling surface phenomenon. The subsequent process of inquiry—a review of the literature and empirical evidence, and a hypothesis—also conformed with the critical-realist framework. The solution also corresponded to critical-realist ideas because the authors' hypothesis fit the available evidence better than other hypotheses did. However, the hypothesis described only one possible mechanism and lacked structural grounding.

The authors found that excessive emphasis on econometric techniques (formalism) is detrimental to other empirical methods (e.g., case studies) and to realistic theory development (a theory of the causes of the euro's decline). These techniques do not provide a basis for hypothesizing causal

mechanisms and can be misleading when they incorporate false theoretical perspectives of new classical or New Keynesian economics. Consequently, the authors augmented their econometric solution with other research, which outlined the social structural factors and individual activities contributing to the euro's decline and the perception that the eurozone was weakened by the single currency, leading to market participants' investing outside the eurozone. A combination of social structures and mechanisms and their reproduction by agents (all endogenous to the inception of the euro) were hypothesized to account for the fall in the euro's external value. At the relatively concrete level, the critical-realist method has a strong resonance. However, more abstract and fundamental factors that were involved in the fall in value of the euro were not readily accommodated within the critical-realist framework.

The authors' analysis of the weaknesses of the eurozone drew upon theoretical preconceptions that were explicitly Keynesian in character and formed a specific approach to radical political economy. In practice, theorists do not start by "retroducing" from some surprising proposition, but are guided by more abstract and fundamental theoretical propositions (in this case, Keynesian, Kaleckian, and Marxist theory). Whereas the critical-realist approach starts with abstraction (identification and hypothesis) followed by synthesis, this pattern does not occur at the fundamental level of theorizing, which attempts to fathom the interconnection among known structures, mechanisms, and events in the economy and society. According to the authors, the great contribution of Keynes, Kalecki, and Marx was to provide an orientation by abstracting from and, simultaneously, attempting to understand interconnections existing in a vast array of known social material, as opposed to hypothesizing.

At the more concrete level, some role may be played by ad hoc factors, such as surprise, and by speculative hypotheses (retroduction) of the unknown, as advocated by critical realists. However, based on their EMU work, the authors believe that critical realism is inappropriate for the fundamental level of abstraction, where the key propositions of economics and social theory are formulated.



## Managed Care, Physician Incentives, and Norms of Medical Practice: Racing to the Bottom or Pulling to the Top?

DAVID J. COOPER and JAMES B. REBITZER

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[www.levy.org/docs/wrkpap/papers/353.html](http://www.levy.org/docs/wrkpap/papers/353.html)

Health maintenance organization (HMO) networks have become an important part of the managed care industry. They typically do not employ physicians, but maintain contracts with them that include monetary rewards for controlling medical utilization costs. These contracts are the source of intense public controversy and high-stakes litigation, since information asymmetries prevent patients from directly evaluating the quality of care provided by their physicians, leading to fears that competition will trigger an HMO-led “race to the bottom” in which physicians operate under severe cost controls and managed care plans offer minimal levels of care.

David J. Cooper and Research Associate James B. Rebitzer of the Weatherhead School of Management of Case Western Reserve University combine a model of differentiated product oligopoly with a model of physician incentives to study how competition among HMOs shapes the practice style of physicians and the welfare of their members. Their model solves for both physician-incentive contracts and HMO market strategies in an environment of extreme information asymmetry, in which physicians perceive the quality of care perfectly while their patients do not perceive it at all. Central to the analysis are the process by which HMOs assemble physician networks and the role these networks play in the competition for customers. Attracting large numbers of physicians requires HMOs to write relatively low-powered incentive contracts. The model assumes that potential HMO members have preferences for the size of physician networks and the cost of insurance. The competitive strategy is the resulting tradeoff between providing large physician networks and maintaining low costs.

Norms of medical practice have both an exogenous and an endogenous component. Exogenous factors such as the state of medical knowledge, medical ethics, and the threat of malpractice suits determine the minimum-cost practice style tolerated by a physician. Endogenous norms are based on

relative levels of care provided by other physicians, and amplify forces that move the market away from a “race to the bottom” and reduce the scope for product differentiation among HMOs. Based on evidence from other studies, the model assumes that physicians respond to financial incentives by changing their practice style and are shaped by absolute and relative practice norms, and that HMOs take these norms into account when writing incentive contracts.

Competition among HMOs is modeled as an extensive form game with three stages: HMOs simultaneously set their doctor and member sizes, and prices are set to clear the market; HMOs write physician-incentive contracts; and doctors decide which HMO to join and what medical practice style to adopt. Subgame perfection is used as a solution concept, and the model solves for the equilibrium values of the number of doctors and patients for each HMO via backward induction, i.e., exposition of the model begins with the final stage and works backward in time.

HMOs write linear incentive contracts with two parameters—a capitation rate (a flat fee per patient) and a cost share (the fraction of incurred medical costs borne by the physician)—which are chosen to minimize per-patient costs subject to the participation constraints required to meet selected network size and number of doctors. Increases in incentives to control costs have the effect of reducing the cost of adopted practice styles. The marginal physician’s judgment of the minimum acceptable style, rather than the marginal HMO member, determines the style that prevails in a particular HMO. Therefore, an HMO’s costs depend on the size of another HMO’s network, and the size of the cost spillovers depends on the strength of the physician’s relative practice norms. Consumer preferences such as larger networks are then considered, using the strong assumption that they cannot perceive the style of care, or infer this style from network size.

A “race to the bottom” in the quality of care would occur if HMOs responded to competitive pressures by slashing costs when employing powerful incentive contracts with physicians. Consumers, unable to judge care quality, would end up receiving increasingly poor medical care, and “hitting bottom” would occur when HMOs uniformly offer the lowest feasible level of care. This, however, does not occur, because the result is driven by the presence of absolute practice norms. The need to persuade at least some physicians to

join particular networks forces all HMOs to induce a style above the minimum, and the market subsequently offers differentiated products and practice styles. Unlike many other businesses, an HMO does not necessarily become a stronger competitor by cutting its costs. Tougher cost-control incentives come at the price of offering a less attractive product, i.e., a smaller physician network. Therefore, in a world with product differentiation, HMOs don't "race to the bottom," but rather to their market niche. Relative practice norms act as a "pull to the top" as low-cost HMOs closely approximate high-cost HMOs in terms of incentives and market strategies. An elevation of physician practice norms helps consumers who care most about access to large networks, but harms those who are most sensitive to prices.

Cooper and Rebitzer consider two broad regulatory strategies for shaping physician incentives: imposing caps on the proportion of "at risk" income allowed in physician incentive contracts, and making HMOs legally liable for adverse medical consequences attributed to their cost-containment systems. The first strategy results in HMOs' increasing their network size, leading to increases in the marginal cost of serving an additional patient. The second increases fixed costs per patient and raises the incidence of various forms of "defensive" medical practices, as a result of possibly increased jury awards. Therefore, both strategies have the likely effect of increasing both medical costs and the number of uninsured patients.

According to the authors, regulating physician incentive systems is not necessarily a bad policy idea. There are important externalities that may not be fully captured, such as health outcomes (the welfare of related caregivers and family members) and the physician-patient relationship. If the net social value of more expensive practice styles or contract restrictions exceeds the private value, there remains a strong case for interventions that limit ways in which HMOs regulate care. Policy interventions therefore must take into account their associated costs, especially the increase in the number of the uninsured, and be implemented in conjunction with policies that increase access to care for the uninsured.

Cooper and Rebitzer cite unresolved empirical and theoretical issues, particularly the formation and operation of physician practice norms. Further norm research is critical, they say, to understanding the impact of incentives in health

care and other settings where outcomes hinge on the decisions and actions of highly skilled professionals.

## New Research Staff

The research agenda of Institute Professor of Economics Philip Arestis is varied and wide. His most recent work has concentrated on aspects of the European Union related to monetary union, such as the historical and institutional framework of the European Monetary Union (EMU), deflationary consequences of the EMU, the shaping of new institutions such as the European Central Bank, and the type of institutional framework necessary to generate higher levels of employment. His other areas of research interest include current monetary policy, the relationship between finance and growth and development, the regime-switching approach to the European Monetary System, capital stock in wage and unemployment determination, the “third way,” inflation targeting, threshold effects in the U.S. budget deficit, and the role of Minskian economics and financial liberalization in the southeast Asian crisis.

Most recently, Arestis was professor of economics and director of research at the Business School of the University of South Bank, London, where he also was codirector of the Centre of Monetary and Financial Economics. Previously, he had been research professor and head of the Department of Applied Economics at the University of East London and head of the economics division at Greenwich University. He has lectured at the University of Surrey and the University of Cambridge and been a visiting professor in the department of economics at Candido Mendes University in Rio de Janeiro.

Arestis has published extensively in and served as a referee for journals including *Economic Journal*, *Journal of Macroeconomics*, *Cambridge Journal of Economics*, *Economic Development and Cultural Change*, *Manchester School of Economic and Social Research*, *International Review of Applied Economics*, *Journal of Economic Studies*, *Oxford Economic Papers*, *Scottish Journal of Political Economy*, *Structural Change and Economic Dynamics*, and *World Development*. He is a member of the editorial board of *Eastern Economic Journal*, *Journal of Post Keynesian Economics*, *International Review of*

*Applied Economics*, *Applied Economics*, *Applied Financial Economics Letters*, *Review of Social Economy*, *International Papers in Political Economy*, *Zagreb International Review of Economics and Business*, and *Ekonomia*.

Arestis received a B.A. in economics from the Athens Graduate School of Economics and Business Studies, an M.Sc. in economics from the London School of Economics, and a Ph.D. in economics from the University of Surrey.

Research Scholar Asena Caner is working with Senior Scholar Edward N. Wolff and Research Scholar Ajit Zacharias on designing the Levy Institute Measure of Economic Well-Being. The measure, which will describe the level and distribution of well-being in the United States, incorporates the multidimensionality of the concept of economic well-being and will be used as a tool to monitor improvements (or lack thereof) in well-being. Caner’s research interests include the role of household wealth in poverty and inequality, wealth distribution, the relationship between entrepreneurship and household wealth accumulation, and the measurement of income flows from household assets. She received a B.S. in industrial engineering from the Middle East Technical University in Ankara, Turkey, and master’s degrees in economics from North Carolina State University and New York University. She is a Ph.D. student in economics at New York University.

## PUBLICATIONS AND PRESENTATIONS

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### PUBLICATIONS AND PRESENTATIONS BY LEVY INSTITUTE SCHOLARS

PHILIP ARESTIS *Institute Professor of Economics*

**Publications:** “Emergence and Evolution of Cross-Border Banking: Evidence From the UK” (with L. Deidda and B. Fattouh), *Greek Economic Review*, Autumn 2002; “Euro Fall Points to Failure at Its Institutional Heart” (with Malcolm Sawyer), *The Guardian*, September 9; “Is There a Trade-off between Inflation and Output Gap?” (with G. M. Caporale and A. Cipollini), *The Manchester School of Economic and Social Research*, Special Issue, 2002.

JÖRG BIBOW *Research Associate*

**Publications:** “On Convention: Keynes, Lewis and the French School” (with J. Runde and P. Lewis), in S. Mizuhara and J. Runde, eds., *Perspectives on the Philosophical Underpinnings of Keynes’s Economics: Probability, Uncertainty and Convention*, London: Routledge, 2002; “Maynard Keynes on Central Banking and the Structure of Monetary Policy,” *History of Political Economy*, Winter 2002.

**Presentation:** “On the ‘Burden’ of German Unification: The Economic Consequences of Messrs. Waigel and Tietmeyer,” Annual Conference of the Money, Macro, and Finance Research Group, University of Warwick, UK, September 4–6.

WALTER CADETTE *Senior Scholar*

**Publication:** “A Bull in Sheep’s Clothing,” *Research Reports*, American Institute for Economic Research, September 23.

**Presentation:** “Financing Long-Term Care,” North Shore University Hospital, Great Neck, New York, September 12.

JAMES K. GALBRAITH *Senior Scholar*

**Publications:** “Can We Please Move On? A Contribution to the Guerrien Debate,” *Post-Autistic Economics Review*, September 2002; “A Perfect Crime: Inequality in the Age of Globalization,” *Daedalus*, Winter 2002; “If This Is a Hangover, the Exuberance Was Rational,” *Washington Post*, July 21.

**Presentations:** “Globalization and Inequality,” EPIIC, Tufts University, Medford, Massachusetts, March 1; “The War Economy,” LAMP, University of Texas, Austin, April 16; “Globalization and Inequality,” World Bank, June 18; “Globalization and Inequality,” Middlesex University, London, June 19; keynote speaker, Post Keynesian Conference, University of Missouri, Kansas City, June 30; “The Enduring Importance of Maynard Keynes,” Seminar on British Studies, University of Texas, Austin, August 30.

MALCOLM SAWYER *Research Associate*

**Publication:** “Euro Fall Points to Failure at Its Institutional Heart” (with Philip Arestis), *The Guardian*, September 9.

GWYNETH H. CROWLEY *Head of Information Services*

**Publications:** “Probing User Perceptions of Service Quality: Using Focus Groups to Enhance Quantitative Surveys” (with Charles L. Gilreath), *Performance Measurement and Metrics: The International Journal for Library and Information Services*, 3.2, 2002; “Rosie the Riveter,” *The Scribner Encyclopedia of American Lives*, Volume Five, New York: Charles Scribner’s Sons, 2002.

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