The Jerome Levy Economics Institute of Bard College

Summary

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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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Letter from the Executive Director

To our readers:

This issue of the Summary *includes activities in all our research programs. I would especially like to call your attention to the summary of the congressional policy briefing by Distinguished Scholar Wynne Godley and Visiting Senior Scholar Jan A. Kregel. The briefing provided key insights into current and future effects of the Asian financial crisis on the United States and the world.*

Six working papers in the area of employment and labor market structure are summarized. Senior Scholar L. Randall Wray discusses the possibility of achieving both full employment and price stability by using the government as "employer of last resort." Visiting Scholar Mathew Forstater, of Gettysburg College, suggests the selective use of discretionary public employment as a way to maintain full employment without *generating inflationary pressure. Resident Scholar Oren M. Levin-Waldman makes a case for linking increases in the minimum wage to productivity gains. Three papers originally presented at the symposium on immigration at the Levy Institute last fall are summarized. John Mollenkopf, Philip Kasinitz, Nancy Lopez, and Dae Young Kim, all of the Graduate Center of the City University of New York, and Mary C. Waters, of Harvard University, present some preliminary results of their pilot study on the school-to-work transition of the children of immigrants in New York. Rubén G. Rumbaut, of the Russell Sage Foundation and Michigan State University, reports on a similar study of the children of immigrants in California and Florida. Waters discusses the impact of racial segregation on West Indians in New York City.*

Two papers are summarized in the area of restructuring in the financial services sector. In one of them, I discuss the potential role of community development banks in improving prospects for members of the underclass. The other paper is the first in a number of papers to be issued in which L. Randall Wray and I will assess the contributions of Hyman P. Minsky to economic theory and policy for institutional reform.

One working paper is summarized in each of the programs on international trade and competitiveness and federal budget policy. Chris Tilly and Michael Handel, both of the Center for Industrial Competitiveness at the University of Massachusetts Lowell, use case studies to analyze the diagnostic imaging equipment industry. L. Randall Wray discusses the history and development of the chartalist approach to the definition, supply, and value of money.

Under special projects Mathew Forstater discusses the policy formulation process and Visiting Scholar Malcolm Sawyer, of the University of Leeds, considers the relevance of Kalecki's analysis of capitalist economies in light of institutional changes that have occurred since Kalecki did his major theoretical work.

As always, I invite your comments on the Summary.

Dimitri B. Papadimitriou
Executive Director

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Institute Research

Program: Employment Policy and Labor Market Structure

Summaries of New Working Papers

Government as Employer of Last Resort: Full Employment without Inflation
L. Randall Wray
Working Paper No. 213, November 1997

Since the Employment Act of 1946 a stated policy of the U.S. government has been to pursue simultaneously high employment and stable prices. However, because many economists and policymakers do not believe that it is possible to have both high employment and stable prices, monetary policy has generally been geared, at least for the past two decades, toward increasing unemployment as a means to achieving stable prices. Senior Scholar L. Randall Wray demonstrates that stable prices and "truly full employment" are in fact compatible with each other if a properly targeted employment program is used.[1]

Wray advocates that the government become the "employer of last resort" (ELR); it would announce the wage at which it will hire anyone who wants to work in the public sector and then hire all who seek employment at that wage. He estimates the net cost of an ELR program with a wage of $6.25 per hour to be between $25 and $50 billion: $100 billion in wages for the 8 million unemployed minus $50 to $75 billion of savings in unemployment insurance benefits, AFDC, food stamps, and other income maintenance programs that could be replaced by ELR. Programs for those unable to work, such as Social Security and SSI, would be unaffected.

According to Wray, ELR will not eliminate all inflationary pressures that may arise, but it will maintain full employment without itself being the source of inflation as long as ELR, and only ELR, is financed by deficit spending. This will ensure that the deficit, and hence aggregate demand, will rise only to the point at which involuntary unemployment is eliminated, but not farther. The pool of ELR workers will be a countercyclical "buffer stock" of available labor that will act as an automatic stabilizer; it will automatically shrink at the top of the business cycle to reduce the upward pressure on wages and prices and expand during recessions to prop up a slack aggregate demand. Thus, the deficit will not cause demand to become excessive and therefore will not be a source of inflationary pressure.

Wray responds to several potential criticisms of ELR. First, critics may argue that it would be impossible to administer the program because of incompetence, corruption, racism, and opposition. Wray admits that these may be problems, but contends that they are problems throughout the private sector and the current social welfare system and that they are problems that must be faced and overcome by our society. Second, critics may argue that ELR jobs will become "make work" jobs. Wray believes we need not fear this because there is a long list of valuable uses to which public sector labor could be directed, and in the worst case it is better to have the unemployed working than receiving "money for nothing." Third, critics may argue that ELR is not needed because states are already implementing "welfare to work" programs. Wray explains that states cannot run the continuous deficits needed to finance ELR. During economic downturns, when ELR is most needed, states will find unemployment rising and tax revenues falling. They will not be able to expand spending to provide jobs for the unemployed. Only the federal government can finance ELR in the worst of times. Fourth, critics may worry about ELR workers who do not really want to work. Wray believes discipline can be maintained by the promise of promotion on the positive side or by moving their employment to a day-by-day or even hour-by-hour basis on the negative side. Fifth, Wray admits that ELR cannot replace social spending for those who simply cannot work. Sixth, critics may claim that ELR workers will undermine public sector union workers. Wray agrees that this must be prevented, but believes it can be done by giving ELR workers new functions so they do not replace existing government employees. He also thinks that ELR will have a positive effect on unions because it will establish an effective alternative to private sector employment, increasing unions' bargaining power. Seventh, critics may argue that ELR workers will be stigmatized. Wray admits that this is a danger and one that must be minimized, but asserts that the stigma will be less than for current recipients of welfare and unemployment insurance. Eighth, critics may argue that unemployment is no longer a problem; it has fallen to its lowest level in a generation. Wray counters that this line of reasoning sees having 8 million unemployed as accept-able or, in any case, as the fewest the economy can ever hope for.

Wray concludes, "Other objections will be raised, problems will crop up, further analysis is needed. However, if the primary issues can be resolved, then we can turn to these details."

Note

1.The term "full employment" is usually taken to mean a 3 to 6 percent unemployment rate, allowing for frictional unemployment. Truly full employment is an unemployment rate of zero.

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The School to Work Transition of Second Generation Immigrants in Metropolitan New York: Some Preliminary Findings

John Mollenkopf, Philip Kasinitz, Mary C. Waters, Nancy Lopez, and Dae Young Kim
Working Paper No. 214, November 1997

Social scientists have only begun to study the experiences of the 15 million immigrants who have settled in the United States since 1965 and have learned even less about their children. Several speculate that the children of immigrants, being restricted to poor inner city schools, bad jobs, and shrinking economic niches, will experience downward mobility or "second-generation decline." Others postulate a "segmented assimilation," in which some second-generation youth will develop an "adversarial stance" toward the dominant society and will assimilate, but into the American "underclass."

John Mollenkopf, of the Graduate Center of the City University of New York; Philip Kasinitz, of the Graduate Center and Hunter College; Mary C. Waters, of Harvard University; and Nancy Lopez and Dae Young Kim, both of the Graduate Center, have undertaken a detailed study of the school experience, labor market outcomes, and social incorporation of the current second generation as its leading edge enters adulthood. The authors are in the early stages of an empirical study of young adults (age 18 to 32) in the New York metropolitan area who were born in the United States to post-1965 immigrant parents or who were born abroad but arrived in the United States by age 12. They compare the largest groups from the three major streams of immigration in the New York metropolitan area—Anglophone West Indians, Dominicans, and Chinese—with young adult native-born whites and blacks and mainland-born Puerto Ricans. The authors present the results of a pilot study conducted to test alternative sampling strategies for the full survey—a large-scale telephone survey, in-depth in-person interviews with a subsample of survey respondents, and ethnographies. The function of the pilot study was to refine the methodology for the main study, but the data do lead to a few tentative findings, or "well-informed hunches," as the authors prefer to call them.

All groups expressed a strong belief that educational success was the key to success in the economy, but the meaning of "educational success" varied greatly among groups. For some, graduating from high school was considered doing well; for others, good grades and a college degree were required. Follow-up questions in the interviews revealed that West Indian, Dominican, and Haitian respondents harbored considerable skepticism about the value of educational credentials in the face of a racially divided job market. Gender differences appear to influence educational performance. In all ethnic groups studied except Chinese, girls tended to reach higher levels of educational achievement than boys.

Labor market outcomes appear to be most favorable for the second generation in groups in which the first generation brings higher social status and human capital into the marketplace. In other ways, however, the various second-generation groups seem more like each other and more like native working-class New Yorkers than like their immigrant parents. For example, many children of immigrants display behaviors associated with "oppositional" culture, and so do many native white and black Americans. These behaviors, however, are not always a barrier to employment. The authors speculate that the effect of oppositional attitudes on labor market outcomes depends greatly on the condition of the overall economy.

The authors reach four tentative conclusions that they hope to examine further in the main study. First, the study of the second generation must be a study of distinct groups, not of the operation of various individual and familial factors across all immigrant groups. Second, the expectation of second-generation decline needs to be reassessed. Third, school, not work, is the key to the future. Fourth, ethnic concentration has advantages and disadvantages. Labor market concentration, in the form of ethnic job niches, may constitute a group resource, at least for the first generation, but residential concentration has strong adverse consequences, including poor schools and fewer public resources.

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Achievement and Ambition among Children of Immigrants in Southern California

Rubén G. Rumbaut
Working Paper No. 215, November 1997

The influx of immigrants to the United States after 1965 has reached levels not seen since the early part of the century. The ability of these recent immigrant groups and their children to succeed in the American economy has been hotly debated but, until recently, little studied. Rubén G. Rumbaut, a professor of sociology at

Michigan State University and a visiting scholar at the Russell Sage Foundation, summarizes the results of a study designed to examine the educational performance and social, cultural, and psychological adaptation of children of immigrants. Since 1991 the Children of Immigrants Longitudinal Study (CILS) has followed the progress of a large sample of teenage youths in Florida and California. In 1992 researchers interviewed over 5,200 eighth- and ninth-grade students in the San Diego, Dade County, and Broward County school districts. In 1995 and 1996 a second survey of the same group was conducted, supplemented by in-depth interviews of a stratified sample of their parents. The respondents were divided into seven groups by national/ethnic origin: Mexican, Filipino, Vietnamese, Cambodian, Lao, Hmong (a cultural and linguistic minority group in Laos), and others. About three-fourths of respondents had parents who were co-nationals. The rest were classified by their mother's origin unless the mother was U.S. born, in which case they were classified by their father's nationality.

According to Rumbaut, "the overall picture that emerges from our study is one of noteworthy achievement and resilient ambition." In many respects the patterns for these children of immigrants are much like the patterns for children of nonimmigrant, nonminority parents. Factors that appear to be associated with success in school are low-conflict and intact families, higher socioeconomic status, ambitious parents and peers, safer schools, and less television. Factors that significantly add to the develop-mental challenges faced by the children of immigrants include low competence in English, contextual dissonance, foreign birth and recency of arrival, entry into minority experiences and expectations of discrimination, and the acculturative stress and intergenerational conflict that accompany assimilation and discrimination.

Rumbaut identifies "challenge-and-response" patterns he calls the "gender paradox" and the "achievement paradox." Being in a position of low status, such as being female or a recent immigrant, is associated with higher educational achievement and aspirations but also with lower self-esteem and more depressive symptoms.

Contrary to alarms among some native-born, nonminority groups about the perpetuation of foreign-language enclaves in immigrant communities, Rumbaut finds that there is a strong linear pattern of rapid linguistic assimilation across nationalities and socioeconomic levels, suggesting that fluency in non-English languages will inevitably decline among the descendants of recent immigrants, just as it did for the major groups that arrived earlier in this century. Even within the subgroup that has been found to be the most retentive of its native language—Mexican-Americans living along the Mexican border in communities with a large number of Spanish speakers—79 percent of immigrants' children born in the United States answered in the 1995 survey that they preferred English. This suggests to Rumbaut that recent immigrants groups will follow the pattern of previous immigrants and by the third generation will be virtually only English speaking.

Rumbaut is continuing to analyze the data to seek to disentangle the effects of ethno-national background from those of family socioeconomic status, peer groups, school, neighborhood, and the individual characteristics of each student.

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The Impact of Racial Segregation on the Education and Work Outcomes of Second Generation West Indians in New York City

Mary C. Waters
Working Paper No. 216, November 1997

Mary C. Waters, a professor of sociology at Harvard University, examines one way in which race matters in the United States by studying black children of immigrants in New York City. She demonstrates that the segregation and concentrated poverty in black neighborhoods have long-lasting effects on the acquisition of skills. These youth face direct employment discrimination by employers, and in response to discrimination many develop an oppositional attitude, refusing to take jobs in which they feel they must show deference to white supervisors. "Even the most non-oppositional, un-race conscious, ambitious, school-identified youth would face a very uphill battle to avoid crime and violence, do well in school, and get enough education in a local school to actually complete college."

Waters examines the effects of segregation on black West Indian immigrants and their children in Brooklyn. Her data come from a 1990 to 1992 field study in New York City of black immigrants to the United States from the Caribbean. The study included 212 first-generation immigrants, 27 native-born whites, 30 native-born blacks, and 83 adolescents who were the children of black immigrants from Haiti and the English-speaking islands of the Caribbean.

Waters cites research showing that in the United States racial segregation for blacks is more extensive than for any other ethnic group. Active discrimination and institutional racism lead to fewer city services and less private investment in residentially segregated neighborhoods. Blacks are highly segregated at all levels of income. Middle- and working-class blacks, seeking better schools and less crime, purchase housing in predominantly white neighborhoods, but white flight and bank redlining lead to declining property values in those neighborhoods, decreasing investment, and increasing poverty and crime.

According to Waters, education is now more important than ever to socioeconomic advancement. The decline of manufacturing and the growth of the service sector have created an "hourglass" economy, with good, well-paid jobs at the top, low-wage jobs at the bottom, and not much in between. Yet, getting an education is difficult for black immigrants in segregated neighborhoods. The academic standing of New York City schools tends to follow the socioeconomic status of the neighborhood. Although students in poor black neighborhoods tend to arrive at school with lower abilities and therefore needing the best teachers, the good and experienced teachers are the ones who get the chance to move to better schools, leaving behind the inexperienced and burnt-out teachers. Many of the youth surveyed by Waters feel that teachers, who are in many schools predominantly white, do not care about the students because they are black. Violence is another serious problem at inner-city schools; many students and teachers reported having witnessed stabbings or shootings on or near school grounds, and some admitted to carrying weapons themselves.

Individual students and teachers are outstanding, but the successes are few. Eisenhower, a four-year high school in Waters's study, graduates only 175 students a year out of a student body of 2,600. Waters concludes that segregation dashes families' hopes that their children will acquire the skills necessary to get the kinds of jobs they want.

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Selective Use of Discretionary Public Employment and Economic Flexibility

Mathew Forstater
Working Paper No. 218, December 1997

Flexibility and full employment are desirable features in any economic system, but there appears to be a trade-off between the two in the modern capitalist economy. Flexibility is the ability of the production system to respond to structural and technical change quickly. According to Visiting Scholar Mathew Forstater, of Gettysburg College, the modern capitalist economy maintains flexibility by relying on a large pool of available unemployed workers. Flexible systems are more conducive to economic growth and low inflation than inflexible systems, but if the society must tolerate high unemployment in order to achieve flexibility, there is a question as to whether flexibility is worth the cost.

Standard economic models are able to portray a system that adjusts instantaneously to all structural and technological changes by making unrealistic assumptions that eliminate all sources of rigidities. The unrealistic assumptions include fully flexible prices, perfect information, no historic time, and factors of production that are perfectly mobile, substitutable, and homogeneous. Because the models do not take some sources of rigidity into account, they are of little use in designing policies to increase flexibility.

According to Forstater, the modern capitalist economy is flexible to some extent, but not in the apparently costless way that economists' contrived models are flexible. Capitalism creates a systemwide reserve pool of unemployed labor that allows firms to increase their workforce when demand is unexpectedly high and helps hold down wages by weakening the bargaining position of labor. This reserve pool of workers is necessary to counteract the rigidity of capital stock. Because the existing capital stock depends on a given mode of technology, it cannot adapt quickly enough to meet unexpected changes in the supply of natural resources, the supply of labor, or the level of technology. Imports, shift work, overtime, intensification of production, running down inventories, and postponing the scrapping of equipment can add some flexibility to the system, but they do not add enough to maintain flexibility at full employment. Therefore, the system needs a large pool of available labor to maintain flexibility.

Unemployment may maintain flexibility, but it does so at a high social and economic cost. Unemployment causes permanent losses in potential output, higher government spending in public assistance, the deterioration of labor skills, and other economic, social, and psychological problems, such as crime, ill health, divorce, and suicide. In light of these deleterious consequences, the benefits of full employment outweigh the costs.

Forstater suggests that discretionary public employment can reconcile the trade-off between full employment and flexibility. By "discretionary" he means employment in activities that provide public benefit, but may not be required for the regular, or necessary, activities of government, Discretionary employees would be employed but still available for firms to draw on in times of peak demand. Discretionary public employment could thus provide the flexibility that is currently achieved by having a "reserve army of the unemployed," but without any unemployment and without its social and economic costs.

The ability of government to disregard narrow profit considerations allows it to do at least two things that private firms cannot: It can employ labor simply because that labor would otherwise be unemployed, and it can employ labor in whatever type of production is best for the economy as a whole. If capital is in short supply, government can employ labor to produce goods that use little or no capital or enhance the supply of capital. It can avoid production that uses scarce natural resources or select work projects to develop renewable substitutes for exhaustible natural resources. Discretionary public employment can be used in any community to create a way to avoid dislocation of local workers. According to Forstater, discretionary public employment will produce numerous public benefits and promote full employment without sacrificing flexibility or causing inflation.

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Linking the Minimum Wage to Productivity

Oren M. Levin-Waldman
Working Paper No. 219, December 1997

The 1996 legislation increasing the minimum wage did not remove further increases from the political agenda; the increase was not sufficient to raise many families out of poverty and inflation erodes the real value of the minimum wage. Congress will be forced repeatedly to tackle the issue and to become embroiled in the same political debate. Resident Scholar Oren M. Levin-Waldman makes a case for rectifying this problem by adjusting the minimum wage automatically, with increases tied to private sector wages and thus to productivity.

First, he asserts that it is a simple matter of fairness that those who work full-time should be able to support themselves and their family above the poverty line. Every time the minimum wage needs an inflation adjustment, Congress rehashes the old debates about the legitimacy of the minimum wage itself. This means that by the time an increase is adopted, it is usually "too little and too late." The result of repeated debate has been that the minimum wage has fallen from over 56 percent of average wages in 1968 to just over 37 percent in 1995.

Second, Levin-Waldman attacks arguments that a minimum wage increase will have deleterious side effects. He surveys empirical research and concludes that the data are not sufficient to make definitive statements about effects of the minimum wage, be they positive or negative. Levin-Waldman argues that economic theory predicts that a minimum wage, if effective, will do one of two things: It will result in the layoff of those workers whose marginal product is less than the minimum or it will result in an increase in productivity among low-wage workers. Most economists ignore the second possibility and assume that a minimum wage causes unemployment and an increase in the minimum wage will increase unemployment. However, higher wages give employers and employees alike incentive to reduce turnover and to invest in training and technology to make workers more productive so that their marginal product rises, which, in turn, could cause an increase in aggregate demand and even reduce unemployment. Thus, Levin-Waldman concludes that there is no solid theoretical backing to the belief that the minimum wage is inefficient. Also, we cannot safely assume that the labor market is perfectly competitive; if it is not, a higher minimum wage will increase the bargaining power of workers.

Third, Levin-Waldman asserts that raising the minimum wage will also help workers making more than the minimum because firms use the minimum wage as a reference point. If this is so, an increase in the minimum wage can cause increases for workers up the pay scale.

Fourth, Levin-Waldman counters the argument that an increase in the minimum wage could drive some firms out of business. He says that even if this were true, the economy would be better off without those businesses. A minimum wage protects firms who pay high wages from being undersold by firms whose only advantage is paying substandard wages.

Fifth, Levin-Waldman cites research showing that the side effects of a change in the minimum wage tend to increase with the size of the change. A productivity index would remove the need for large jumps to keep pace with inflation, replacing these large jumps with small adjustments that are easier for the economy to handle.

Based on all of the above arguments, Levin-Waldman concludes that the minimum needs to be indexed. He claims that the best method for indexing is to link the minimum wage to average low-skilled wages because this would most closely approximate the productivity increases of minimum-wage workers themselves.

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Scholars

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

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

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

Visiting Scholar **Mathew Forstater** is engaged in projects on employment and federal budget policy. He is using a historical, interdisciplinary approach to examine the potential role of full employment policies in the face of deficit reduction and continual technological change. Forstater is an assistant professor of economics at Gettysburg College. He received a Ph.D. in economics from the New School for Social Research.

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

If the objective of policy is to increase the utilization of human capital and, therefore, economic activity so that every race, gender, education, and age group in the working-age population is working close to its capacity, then it is important to understand the aggregate level of underutilization and its distribution within the working-age population. Does the greatest potential lie in reducing economic inactivity among younger or older workers, among males or females, or among less-educated or more-educated workers? The answers to these questions will indicate whether policies targeted at youths (such as Job Corps and youth employment policies), older workers (changes in Social Security and disability benefits), or young women (changes in welfare policy) are likely to be more effective in increasing economic activity. Haveman is the John Bascom Professor of Economics and Public Affairs at the University of Wisconsin, Madison; he received a Ph.D. from Vanderbilt University. Wolfe is a professor of economics, preventive medicine, and public affairs at the University of Wisconsin, Madison; she received a Ph.D. from the University of Pennsylvania.

Research Associate **David R. Howell** is studying the implications of changes in industry characteristics, especially the adoption of information technologies, for employment, skill requirements, and earnings. Specifically, he is examining the effects of recent employment restructuring on young workers by race and gender. In his most recent project Howell attempts to determine if immigrants are taking jobs formerly held by native low-wage workers by examining the relationship between immigration and wages and focusing on specific jobs in specific metropolitan areas in which immigrants are concentrated. He has constructed detailed occupation-industry job contours for the New York metropolitan area for 1980 and 1990 and identified native-born black job niches, a method that allows him to focus on particular areas of the labor market where effects are likely to occur. Howell is an associate professor of economics at the Robert J. Milano Graduate School of Management and Urban Policy of the New School for Social Research. He received a Ph.D. in economics from the New School. He is the author of Public Policy Brief No. 29, *Institutional Failure and the American Worker*.

Research Associate **William H. Lazonick** is conducting research that encompasses issues of global competition, corporate governance, employment, and the distribution of income. Much of the research focuses on the skill-base hypothesis, which posits that human resource investment can take one of two forms: a broad and deep skill base, in which skilled work is conducted by many people at many different levels of the organizational hierarchy, or narrow and concentrated skill base, in which skilled work is conducted by a small and elite portion of an organization's workforce. Lazonick will explore how a difference in skill bases has affected industrial competition between the United States and Japan and whether such skill-based competition has affected U.S. employment. He will also examine statistics on U.S. income distribution from the perspective of the skill-base hypothesis to find (1) the degree of international competition in specific industries and (2) the governance of strategy and learning in a successful U.S. enterprise group. Lazonick is university professor and co-director of the Center for Industrial Competitiveness at the University of Massachusetts Lowell and a visiting scholar at the Euro-Asia Centre of INSEAD (European Institute of Business Administration). He received a Ph.D. in economics from Harvard University. He is the author, with Mary O'Sullivan, of Public Policy Brief No. 37, *Investment in Innovation.*

Research currently conducted by Resident Scholar **Oren M. Levin-Waldman** focuses on restructuring the welfare and unemployment insurance systems to achieve greater efficiency, equity, and effectiveness in the delivery of services and on developing a methodology for analyzing public policy that relies on the application of political philosophy as well as cost-benefit analysis. Recently, he has been examining the effects of a change in the minimum wage, worker displacement due to plant closures, welfare reform and the potential for workforce development, and political realignment in the electorate. Levin-Waldman received a Ph.D. in political science from Temple University. He is the author of Public Policy Brief No. 21, *The Consolidated Assistance Program*; No. 26, *Making Unemployment Insurance Work*; and No. 31, *A New Path from Welfare to Work*. He also is author of *Reconceiving Liberalism: Dilemmas of Contemporary Liberal Public Policy* (University of Pittsburgh Press).

Executive Director **Dimitri B. Papadimitriou**, along with Senior Scholar L. Randall Wray, is currently conducting research to assess the effect of demographic shifts—specifically, the aging of the population—on the labor market in light of the current slow growth in labor force participation rates and based on different ranges of productivity growth. Papadimitriou and Wray will then evaluate the need to revise public policies concerning the retirement age, the Social Security program, and macroeconomic employment policies. They also will continue their work in the program on restructuring in the financial services sector on the appropriateness of using existing price indexes as targets for monetary policy and will apply their findings to OECD countries. In addition to his duties as executive director, Papadimitriou is executive vice president of Bard College and Jerome Levy Professor of Economics at Bard. He received a Ph.D. in economics from the New School for Social Research. He is the author of several Public Policy Briefs: with Hyman P. Minsky, Ronnie J. Phillips, and L. Randall Wray, No. 3, *Community Development Banking*; with Phillips and Wray, No. 6, *A Path to Community Development*, and No. 12, *An Alternative in Small Business Finance*; with Wray, No. 15, *Monetary Policy Uncovered*, and No. 27, *Targeting Inflation*.

Senior Scholar **Joel Perlmann** is guiding a research initiative entitled "Ethnicity and Economy in America--Past and Present." The initiative focuses on the processes by which immigrants and their descendants are assimilated into U.S. economic life. It is hoped that this work will shed light on current policy issues related to immigration, such as international competitiveness, the labor market, income distribution, and poverty.

Perlmann is engaged in three research projects to further this initiative. The first, "The Jews Circa 1900: Social Structure in Europe and America," focuses on social characteristics that help explain the rapid socioeconomic rise of eastern European Jewish immigrants who entered the American economy at the turn of the century. Perlmann is using census data that were previously unavailable or not machine readable to examine social and economic characteristics of eastern European Jewish populations who emigrated to the United States and those who remained in Europe.

Perlmann's second project, "Assimilation and the Third Generation," explores the assimilation of immigrants into the socioeconomic mainstream of the United States and the social and economic experiences of their native-born children. Special attention is paid to a few large groups whose absorption seemed especially slow and painful during the first and second generations: Irish immigrants who arrived in the mid nineteenth century, Italians and Poles who immigrated between 1880 and 1920, Mexicans who arrived throughout much of this century, and southern-born blacks who migrated to the North. Perlmann uses census data in new ways in order to identify and trace second- and third-generation Americans.

Perlmann's third project, "The New Immigration's Second Generation," conducted with UCLA professor of sociology **Roger Waldinger**, reviews literature that deals with the economic progress and difficulties faced by children of immigrants today and compares their experiences with those of children of turn-of-the-century immigrants.

Perlmann, who also holds the post of Levy Institute Research Professor of History at Bard College, received a Ph.D. in history and sociology from Harvard University.

Senior Scholar **L. Randall Wray** is currently working on several projects in the areas of monetary policy, employment, and aging. He is studying the endogenous money approach to macroeconomics and policies to promote full employment focusing on Hyman Minsky's "employer of last resort" proposal. Wray and

Executive Director Dimitri B. Papadimitriou are conducting research to assess the effect of demographic shifts—specifically, the aging of the population—on the labor market in light of the current slow growth in labor force participation rates and based on different ranges of productivity growth. Papadimitriou and Wray will then evaluate the need to revise public policies concerning the retirement age, the Social Security program, and macroeconomic employment policies. They also will continue their work in the program on restructuring in the financial services sector on the appropriateness of using existing price indexes as targets for monetary policy and will apply their findings to OECD countries. Wray has been an associate professor at the University of Denver and a Fulbright Research Scholar at the University of Bologna. He received a Ph.D. from Washington University in St. Louis. He is the author of several Public Policy Briefs: with Hyman P. Minsky, Dimitri B. Papadimitriou, and Ronnie J. Phillips, No. 3, *Community Development Banking* ; with Papadimitriou and Phillips, No. 6, *A Path to Community Development* , and No. 12, *An Alternative in Small Business Finance* ; with Papadimitriou, No. 15, *Monetary Policy Uncovered* , and No. 27, *Targeting Inflation* .

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Program: Restructuring in the Financial Services Sector

Summaries of New Working Papers

The Economic Contributions of Hyman Minsky: Varieties of Capitalism and Institutional Reform

Dimitri B. Papadimitriou and L. Randall Wray
Working Paper No. 217, December 1997

In the first of several papers on the contributions of Hyman P. Minsky, Executive Director Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray assess Minsky's integration of Post-Keynesian theory with an institutionalist appreciation for the varieties of past, current, and feasible future economic institutions. Minsky believed that because there are many types of capitalism determined by circumstances and an evolving set of institutional structures, an abstract economic theory could not be applicable in all times and places but must be institution-specific. Therefore, he focused his attention on the changing institutional structure of developed capitalist economies in the twentieth century.

Minsky refused to accept the interpretation of Keynes that was being popularized in the 1950s by Alvin Hansen and others. He saw this version of Keynesianism as flawed because it was almost a mechanistic use of countercyclical fiscal policy that ignored the role of uncertainty and finance in the complex capitalist economic system. Minsky formulated the ideas of endogenous money, innovation that stretches liquidity, behavioral changes induced by policy, lender of last resort activity, instability-enhancing behavior over the course of the cycle, and an endogenous accelerator, and he developed the financial instability hypothesis (FIH).

The FIH can be summarized in three words: "Stability is destabilizing." The hypothesis has two theorems. First, the economy has financing regimes under which it is stable and unstable. Second, over periods of prolonged prosperity the economy transits from stable financial relations to unstable ones. The reason for this is that the financial position of firms tends to change from conservative hedge financing to speculative financing as periods of prosperity generate exuberant expectations, but these financial positions develop into ponzi positions when expectations become unsustainable.

Based on the FIH, Minsky derived what he called the "anti-laissez-faire theorem," the proposition that in a world where the internal dynamics imply instability, apt intervention and institutional structures are necessary for market economies to be successful. Government intervention—for example, in the form of a central bank capable of acting as the lender of last resort or a big government large enough to be capable of running a countercyclical deficit—is necessary to create ceilings and floors to keep the financial sector within an acceptable range. Papadimitriou and Wray emphasize that the financial instability hypothesis is critically institutionalist in its structure because it relies on the continually evolving nature of financial institutions.

Minsky argued that Federal Reserve willingness to intervene as lender of last resort was needed for stability, but such an action could be dangerous because it would encourage financial institutions to adopt even riskier financial positions. To counter this, Minsky advocated government supervision of banks and policies to reduce the instability-enhancing power of corporations, such as elimination of the corporate income tax (which leads to a bias in favor of debt financing over equity financing) and an "industrial policy" that favored smaller firms and discouraged capital-intensive production.

A necessary tool to stabilize the unstable economy is "big government." Minsky argued that government spending must be as large or larger than private sector investment to enable the government to run countercyclical deficits to offset cyclical swings in investment. He advised reordering spending priorities toward expenditures that increase aggregate supply and aggregate demand together—such as increasing government employment programs and decreasing transfer payments—and away from those that increase only aggregate demand; such reordering would increase output without increasing inflationary pressures. Minsky advocated a truly full employment[1] policy in which the government would act as the employer of last resort. He argued that this could stabilize employment without introducing inflationary pressures into the economy; cyclical fluctuation of private sector employment would be offset by public employment.

Minsky continued to emphasize the dynamic nature of capitalism and to promote the idea that new policies are required to reduce the insecurity caused by the continually evolving institutional structure of capitalism. He argued that the small-government, basically laissez-faire capitalism that failed in the Great Depression was very different from the big-government, big-union capitalism that succeeded in the postwar period, which in turn was very different from today's money manager capitalism, which will be followed by forms of capitalism that differ from today's in as yet unknown ways. Thus, he advocated policy that would constrain instability through creation of institutional ceilings and floors and at the same time address the behavioral changes induced by the reduction of instability. Papadimitriou and Wray conclude that by doing this, "Minsky successfully integrated 'Post-' (or better, 'financial-') Keynesian theory with an institutionalist appreciation for the varieties of past, current, and feasible future arrangements."

Note

1. The term "full employment" is usually taken to mean a 3 to 6 percent unemployment rate, allowing for frictional unemployment. Truly full employment is an unemployment rate of zero.

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Employment Policy, Community Development, and the Underclass

Dimitri B. Papadimitriou
Working Paper No. 220, December 1997

There has been widespread recognition of the existence of an "underclass" in American society, but no consensus on how to address the problem or even how to define it. Executive Director Dimitri B. Papadimitriou defines the underclass as residents in urban neighborhoods characterized by concentrated poverty, joblessness, violence, and a lack of institutions that support the community. Single parents, African Americans, children, and those with less education are overrepresented in the underclass. Papadimitriou proposes community development banks as one policy to address the problem.

According to Papadimitriou, early research on the relationship between the macroeconomy and poverty seemed to support the idea that "a rising tide lifts all boats" because until 1973 poverty dropped as the economy grew. However, more recent experience indicates that it no longer holds true. Despite the economic vitality of the 1980s and 1990s the number of people living in underclass conditions rose alarmingly. In the 1980s a fall in unemployment and a rise in transfers occurred at the same time as an increase in poverty. Papadimitriou attributes this failure of government programs and a growing macroeconomy to reach the most vulnerable members of society partially to the disappearance of the middle-class and middle-class jobs from inner cities, which left the lower class behind to compete for the few remaining jobs and the existing social and economic institutions unable to address the increasing problems of the underclass. This, coupled with the fact that globalization has created an economy with some high-paying, high-skilled jobs but limited prospects for the unskilled could explain why policies designed to enhance macroeconomic activity have not always achieved prosperity for all segments of the population.

Papadimitriou warns that the United States has the worst record of any industrialized nation in providing for its underclass, but sees hope in emulating successful government programs that have been adopted by other developed countries. For example, computer simulations done by Blank and Hanratty show that employing the Canadian system in the United States would result in a 30 percent reduction in poverty among all American families and a 60 percent reduction in poverty among single-parent families.[1]

According to Papadimitriou, targeted neighborhood programs, such as community development banks, can revitalize economically distressed communities. Access to credit is essential for revitalization. Banks perceive loans to very small businesses and low-income households as risky; rising fees and no access to credit have forced a segment of the population out of the traditional banking system. In 1977 only about 9.5 percent of households with income below $12,000 did not have a deposit account, but by 1993 that figure had jumped to 41 percent. Community development banks can provide a safe and secure repository for small savings, and the banks can use these funds from the community as a basis for loans that could play an important role in the economic development of the community.

Note

1. Cited in David Card and Richard B. Freeman, "Small Differences That Matter: Canada vs. the United States," in Richard B. Freeman (ed.), *Working Under Different Rules* (New York: Russell Sage Foundation, 1994).

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Scholars

Cambridge University Visiting Scholar **Stephanie Bell** is applying Hyman P. Minsky's accounting procedures to an analysis of bank reserve accounting, the Federal Reserve Board, and monetary policy formulation. She is also studying the relationship between government deficit spending and bank reserves and the implications of this relationship for monetary policy. Bell received a B.A. in economics and a B.S. in business finance from California State University at Sacramento and an M.Phil. from Cambridge University.

Research Associate **Willem Thorbecke** is investigating the effects of monetary policy on various sectors and segments of the economy. Employing impulse response functions and social accounting matrices, Thorbecke is tracing the effects of monetary policy on different socioeconomic groups during specific time periods (such as the 1979-1982 Volcker deflation and the 1994 preemptive strike against inflation). By examining whether cyclical downturns disproportionately affect different types of workers employed by firms of various sizes, Thorbecke will shed light on how monetary policy affects financial markets and the economy and on how the burden of contractionary policy is distributed among members of society. Thorbecke is an associate professor of economics at George Mason University. He received a Ph.D. in economics from the University of California at Berkeley. He is the author of Public Policy Brief No. 38, *Who Pays for Disinflation?*

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Program: International Trade and Competitiveness

Summary of New Working Paper

The Diagnostic Imaging Equipment Industry: What Prognosis for Good Jobs?
Chris Tilly, with Michael Handel
Working Paper No. 224, January 1998

Diagnostic imaging is the formation of visual images of areas of the body to aid medical diagnosis. Techniques included in this general category are x-ray, single photon emission computed tomography (SPECT), positron emission tomography (PET), ultrasonic imaging, computed tomography (CT), magnetic resonance imaging (MRI), and digital radiography. The devices that accomplish the various types of imaging are among the most technologically sophisticated, rapidly changing products in the world today. This is the type of production in which American manufacturers are expected to excel.

Chris Tilly, of the Center for Industrial Competitiveness at the University of Massachusetts Lowell, with Michael Handel, of the Center for Industrial Competitiveness and the Department of Sociology at Harvard University, assess the diagnostic imaging industry by reviewing the case study literature and visiting American and Japanese firms. They find that although the market share of the major U.S. manufacturers remains secure, the share of second-tier U.S. manufacturers has shrunk.

X rays were discovered by Wilhelm Roentgen in 1895. Within months both General Electric in the United States and Siemens in Germany were marketing the first diagnostic imaging equipment, the x-ray machine, and Japanese manufacturers were in business by 1911. With the invention in the 1960s through 1980s of new techniques, such as ultrasonography and computer tomography, the industry grew significantly.

U.S. and European manufacturers dominated the world market for most of this century, but between 1974 and 1994 Japanese manufacturers increased their market share from 2 to 19 percent. Recently, the saturation of the market in the United States, Europe, and Japan and cost-cutting pressure from public and private sector health care providers have slowed the industry considerably. Most of the sales growth potential for the near future lies in Asia, eastern Europe, and Latin America. The key question for U.S. diagnostic imaging equipment manufacturers is to what extent can they maintain and expand their world market share into these areas. To do so they will have to adapt their procedures to meet challenges from the new competitors.

U.S. firms have responded to the challenges by reducing costs in design and production. As in other U.S. industries during the last 10 years, outsourcing and downsizing have become common. Outsourcing of thousands of parts has allowed some companies to lay off large numbers of shop floor workers and designers; other companies rely increasingly on temporary workers. The result has been fewer jobs, but more good jobs for those with the education to qualify for them. The total effect of outsourcing on wages in all industries has been ambiguous. Wages in diagnostic imaging, as in most other manufacturing industries, have been stagnant in the last 20 years.

Tilly and Handel show a mixed record for U.S. firms in bringing organizational integration into the diagnostic imaging industry. Manufacturing firms in the industry have avidly pursued organizational integration with physicians, hospitals, and government agencies, but have shown less desire to integrate suppliers, engineers, and production workers. All three of these groups have been somewhat disenfranchised by cost-cutting measures. A decade of downsizing has taken its toll on worker loyalty and turnover.

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Scholars

Two accounting-based models form the foundation of much of Distinguished Scholar **Wynne Godley**'s research. The first model tracks the evolution of the U.S. economy using a consistent system of stocks and flows (such as income, production, and wealth). This system of information makes it possible (1) to identify significant trends and magnitudes, suggest policy responses to problems, and gauge economic outcomes and (2) to assess the economic implications of different policy regimes. Godley's findings from this model are to be published as an annual Levy Institute publication. The second model is a "closed" world model in which 11 trading blocs--of which the United States, China, Japan, and Western Europe are four--are represented. This model is based on a matrix in which each bloc's imports are described in terms of exports from the other 10 blocs. From this information and using alternative assumptions (for example, about growth rates, trade shares, and energy demands and supplies), past trends can be identified and the patterns of trade and production analyzed to reveal any structural imbalances.

With Resident Scholar **George W. McCarthy Jr.** and Gennaro Zezza, of the Institute Economic, Financial University Degli, Godley is writing an economics textbook, tentatively titled *Stock-Flow Economics* . The book is based, on a number of models, including a theoretical model as well as the U.S., U.K., and world models. Godley was a member of HM Treasury's Panel of Independent Forecasters, the so-called Six Wise Men. He is a professor emeritus of applied economics at Cambridge University and a fellow of King's College. He is author of Public Policy Brief No. 23, *A Critical Imbalance in U.S. Trade* .

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Program: Federal Budget Policy

Summary of New Working Paper

Money and Taxes: The Chartalist Approach
L. Randall Wray
Working Paper No. 222, January 1998

Senior Scholar L. Randall Wray traces the development of the chartalist approach to money from Adam Smith, Georg Friedrich Knapp, and John Maynard Keynes to the later theorists, including Hyman P. Minsky, Abba Lerner, and Kenneth Boulding, who follow the "endogenous money approach." The chartalist approach is the belief that money is a creature of the state. The state defines what its citizens will use as money by defining what it will accept in payment of taxes. The state supplies this money by spending, and it determines the value of money by setting the conditions under which the population can obtain money (by setting how much the government will pay for goods and services). Thus, it is fiscal policy and not monetary policy that determines the money supply. Because people usually want to hold some extra money, the government has to spend more than it taxes. Deficits, therefore, should be considered the norm, but deficits do not require selling bonds. The government provides bonds to allow the public to hold interest-bearing alternatives to money so that it can hit its interest rate target, not because it needs to sell bonds to obtain money to finance the deficit.

At a time when many people believed that the value of money is determined by the metallic value of coins, Smith recognized that paper money that is not redeemable in specie need not depreciate relative to specie as long as it is accepted in payment of taxes and as long as it is not issued excessively *relative to the tax liability* .

> A prince, who should enact that a certain proportion of his taxes should be paid in a paper money of a certain kind, might thereby give a certain value to this paper money even though the terms of its final discharge and redemption should depend altogether upon the will of the prince. If the bank which issued this paper was careful to keep the quantity of it always somewhat below what could easily be employed in this manner, the demand for it might be such as to make it even bear a premium, or sell for somewhat more in the market than the quantity of gold or silver currency for which it was issued.[1]

Thus, it is not legal tender laws or redeemability that gives paper money its value, but its acceptance in payment of taxes.

Knapp put forward a theory similar to what is now known as the chartalist approach. Knapp noticed that the government could always change the metallic standard by announcing a conversion rate and then all debts would be calculated in terms of the new metal—proving that debts are nominal in character even when a metallic standard exists. According to Wray, Knapp believed that bank notes become money as soon as the state announces that it will accept them as payments and they become definitive when the state uses them to make payments. Knapp recognized in 1905 that the government could drop all convertibility and use only nonconvertible paper money; more than 65 years later the United States adopted such a policy.

Keynes recognized the same principle in his *Treatise on Money* : "At the cost of not conforming entirely with current usage, I propose to include as State-Money not only money which is itself compulsory legal-tender but also money which the state or the central bank undertakes to accept in payments to itself or to exchange for compulsory legal-tender money." Keynes argued further that whether commodity money, managed money (e.g., a gold standard), or fiat money is used, it operates on the principle of state money, and the state is free to choose what will qualify as money.

According to Wray, the modern chartalist approach borrows elements from the endogenous money approach, which has two fundamental precepts: (1) The supply of money expands to meet the demand for money; (2) the central bank has no direct control over the quantity of money. This view goes back at least as far as the banking school of thought in the early nineteenth century. Its opponent, the currency school, believed that an excess of bank notes caused depressions and so the quantity of notes issued should equal the quantity of coin specie. The banking school concluded that private bank notes could never be excessive as long as notes were convertible, because they would reflux to banks. Several theorists have presented similar views. Karl Marx believed that banks, which would readily advance loans in expansions but refuse to grant credit in downturns, were the cause of the business cycle. A similar observation by Keynes was developed by Nicholas Kaldor and later become known as the "horizontalist" endogenous money approach. According to Minsky, "Money is unique in that it is created in the act of financing by a bank and is destroyed as the commitments on debt instruments owned by banks are fulfilled. Because money is created and destroyed in the normal course of business, the amount outstanding is responsive to the demand for financing."[2]

Wray concludes that the state defines money but does not control its quantity. It appears that taxes are paid using bank money, but analysis of reserve accounting shows that tax payments always lead to a reserve drain. According to Wray, "The government does not need the public's money, which, after all, is nothing but a government liability. This means that neither taxes nor bonds 'finance' government spending. Enforcement of the tax liability gives value to money; without an effective tax collection system the value of money would quickly fall toward zero." Thus, hyperinflations, which are usually attributed to the government's "printing too much money," are caused by the collapse of the tax authority. Wray says, "deficits can be too large (or too small), and while deficits do increase the quantity of money, this does not mean that deficits necessarily reduce the value of money. So long as government imposes a sufficiently large tax liability . . . deficit spending need not 'cause inflation.'"

Notes

1. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Cannan Edition (New York: Modern Library, 1937), p. 312.
2. Hyman P. Minsky, *Stabilizing an Unstable Economy* (New Haven, Conn.: Yale University Press, 1986), p. 231.

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Scholars

While at the Levy Institute, Visiting Scholar **David A. Aschauer** is pursuing research interests in two areas of fiscal policy. The first line of research builds on his long-term investigation of the effect of federal expenditures (especially infrastructure investment) on economic growth and development. Aschauer is developing a new methodology for research in this area to provide further empirical evidence linking public capital and the performance of the national, state, and local economies. In his second line of research Aschauer is examining the desirability of a productivity budget for the federal government. He examines reasons for the use of public sector debt rather than current taxation for the financing of public expenditures that raise long-term productivity growth. Aschauer is Elmer W. Campbell Professor of Economics at Bates College. He received a Ph.D. from the University of Rochester. He is the author of "Public Capital and Economic Growth" in Public Policy Brief No. 4, *Public Infrastructure Investment: A Bridge to Productivity Growth?*

Policy Advisor **Edward V. Regan** is actively engaged in issues of corporate finance, pension fund and institutional investment, and financing public infrastructure. Regan, who served for 14 years as comptroller of New York State, is now chairman of the Municipal Assistance Corporation (MAC) for New York City and is a member of the Levy Institute Board of Advisors. He is the author of Public Policy Brief No. 16, *Infrastructure Investment for Tomorrow* .

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Special Projects

Summaries of New Working Papers

Policy Innovation as a Discovery Procedure: Exploring the Tacit Fringes of the Policy Formulation Process

Mathew Forstater
Working Paper No. 221, December 1997

Economist Adolph Lowe's instrumental analysis examines the process of policy formulation as a regressive procedure of discovery. Taking as given a predetermined desired end state, the task of an innovator is to discover the technical and social path from the present position to the end state. The role for the economist in policy formulation, therefore, is not simply to examine the results of current policy, but to discover the means that will lead to the desired end state. Lowe cites others before him who had held a similar perspective—philosopher Charles Sanders Peirce, mathematician George Polya, and chemist Michael Polanyi—but Lowe does not elaborate on the connection between his analysis and theirs. Visiting Scholar Mathew Forstater, of Gettysburg College, investigates the relationship between the work of these scientists and Lowe's instrumentalism.

Polya used heuristics to "study the methods and rules of discovery and invention," using a method he derived from Plato's "analysis" or "solutions backward." According to Polya, problem solving has two parts: analysis and synthesis. Analysis is the mental process of working backward from the resolution to discover the actions that will make the end state achievable. Synthesis is the physical process of working forward from the present state, that is, putting the discovered actions into practice, to achieve the desired end state (the point from which analysis proceeds).

Peirce described the process of "retroduction," in which reasons for entertaining some hypotheses are considered. This is distinct from "deduction," in which reasons for accepting some hypotheses are considered. According to Peirce, retroduction is the first step in scientific reasoning; examining what conditions make a hypothesis true follows naturally from the creative discovery of what hypothesis is worth considering.

Polanyi emphasizes the difference between explicit knowledge (such as using a previously drawn map) and tacit knowledge, which he describes as "knowledge we have of something we are in the act of doing" (such as drawing a map of previously unexplored territory).[1] He describes the recognition of a problem that can be solved as a discovery in itself and contends that tacit knowledge is more critical than explicit knowledge: "Even if we admitted that an exact knowledge of the universe was our supreme mental possession, it would still follow that our most distinguished act of thought consists in producing such knowledge."[2]

According to Forstater, Lowe's instrumentalism is not "new" in that it describes procedures and tactics of problem solving that have long been recognized. His contribution is that he calls for giving these procedures more weight and emphasis and recognizing their potential for enhancing the power and success of planning and policy formulation.

Forstater applies this method to the debate about social planning. Ludwig von Mises and Friedrich von Hayek use a line of reasoning similar to Lowe's and Polanyi's when they say that social planning cannot achieve the efficiency of a market economy because it lacks and inhibits the process of tacit knowledge and discovery. According to Forstater, Mises and Hayek are right to emphasize issues of knowledge, but wrong to single out policy formulators as uniquely unable to employ tacit powers. Forstater credits Robin Blackburn for pointing out that Mises and Hayek's argument that "dispersed knowledge" promotes tacit knowledge and discovery could be used to argue that only workers and not capitalists could effectively manage production just as well as it could be used to argue that capitalists and not social planners can more effectively manage production.

According to Forstater, Lowe suggests that the process of discovery is the same for planners formulating public policy as it is for capitalists: both have successes and both make costly mistakes. Forstater hopes that further work connecting Lowe with his predecessors will prove constructive in the task of refining and improving the effectiveness of policy formulation and planning.

Notes

1. Michael Polanyi, *The Study of Man* (Chicago: University of Chicago Press, 1959), p. 12.
2. Ibid., p. 18.

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The Kaleckian Analysis and the New Millennium

Malcolm Sawyer
Working Paper No. 223, January 1998

Visiting Scholar Malcolm Sawyer, of the University of Leeds, commemorates Kalecki's 100th birthday by considering how Kalecki's macroeconomic analysis of developed capitalist economies should be adapted in light of the institutional changes that have occurred since he did his major work. Sawyer believes that although Kalecki's reputation rests on his theoretical work, his theorizing was firmly based on his perceptions of the institutional, political, and social realities of the economies he sought to analyze and that his work is best viewed as a mixture of "high-brow a-institutional" theory and "low-brow" institution-specific applied theory. Because it is "virtually inevitable that the analysis of any . . . 'middle-brow' theorist will be rendered to some degree obsolete by the passage of time," Sawyer sets out to evaluate to what extent Kalecki's theories are still relevant and how they might be adapted for the new millennium.

Kalecki's name is most closely associated with the phrase "degree of monopoly," but Sawyer contends that his principle of "effective demand" is equally important. According to Sawyer, Kalecki made seven key institutional assumptions reflecting his perceptions of industrialized economies of the 1930s and did not update his assumptions to any significant degree thereafter. (1) Most product markets are oligopolized with markup of price over unit costs influenced by the degree of monopoly. (2) Unit costs are approximately constant up to full capacity utilization. (3) Capitalist economies are characterized by class division. (4) Workers are passive in the sense that they have little influence over real wages. (5) The financial system has a largely passive relationship with the real sector (the sector of productive activity) and the main action arises from the real sector. (6) The international trade position enters into the overall equality between leakages and injections, but the degree of monopoly within the domestic economy is not greatly influenced by international competition. (7) The firm is viewed as a profit-pursuing institution.

Sawyer believes that the first three assumptions are clearly still relevant and focuses on the relevance of the other four in light of three important changes that have occurred since Kalecki made his assumptions in the 1930s: (1) the globalization of productive activity, (2) the globalization of financial markets, and (3) the changing position of workers relative to capital.

Globalization involves a larger role for international trade, cross-border foreign direct investment, and cross-border coordination of production. Sawyer argues that although globalization has undoubtedly affected the degree of monopoly in many industries, the principles of degree of monopoly and effective demand are as relevant as ever in macro- and microeconomic analysis.

Kalecki believed that although initiative lies in the real sector, the financial sector could constrain the real sector if, due to bad expectations, banks do not provide the required credit at unchanging interest rates. According to Sawyer, the growth and fragility of the financial sector force a reevaluation, but the Kaleckian analysis can be readily extended to a consideration of the conditions under which the banking system will extend credit.

Sawyer contends that Kalecki's approach to the labor market suggests that the achievement of full employment without inflationary pressures would require sufficient aggregate demand, adequate capacity, and appropriate institutional arrangements to maintain productivity. He suggests that Kalecki's analysis "needs to be expanded to incorporate the factors, notably the macroeconomic ones, influencing work intensity and labor productivity and the institutional arrangements necessary to underpin full employment."

Sawyer concludes that while Kalecki's analysis relates to a single national economy, there is little reason to limit it to one. "What has changed is the impact which a national government can have on the domestic level of aggregate demand and the degree to which the international financial system is supportive of high levels of aggregate demand across the world," but the principle of effective demand remains applicable at national, regional, and global levels.

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Scholars

Senior Fellow **Walter M. Cadette**'s areas of special interest include health care, international trade, and regulation of financial institutions. In addition to his work at the Levy Institute, he is chairman of the Holy Cross Health System's investment review committee. Cadette is a retired vice president and senior economist of J.P. Morgan & Co. Incorporated and was editor of and contributor to its publications *Global Data Watch* and *World Financial Markets*. He received an M.A. from Georgetown University and did further graduate work in economics and finance at New York University. He is author of Public Policy Brief No. 30, *Prescription for Health Care Policy*, and No. 34, *Safeguarding Social Security*.

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

Feder is an assistant professor of economics at Bard College. She received a Ph.D. in economics from Temple University. Hudson is a visiting scholar at New York University. He received a Ph.D. in economics from New York University. Feder and Hudson are co-authors of Public Policy Brief No. 32, *What's Missing from the Capital Gains Debate?* and with G. J. Miller, of *A Philosophy for a Fair Society* (Shepheard-Walwyn).

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Institute News

Conferences

Eighth Annual Hyman P. Minsky Conference on Financial Structure, April 23-24

The theme of the conference this year is "The Fragility of the International Financial System: Options for Policy." Topics to be discussed include causes and solutions of international banking crises, globalization and economic development, the global lender of last resort function, and asset market inflation and deflation. Among the participants are:

James Barth, Auburn University
Albert Fishlow, Council on Foreign Relations
James K. Glassman, American Enterprise Institute
Wynne Godley, Levy Institute
Martin Gruenberg, Senate Committee on Banking, Housing and Urban Affairs
Homi Kharas, World Bank
Jan A. Kregel, Levy Institute; University of Bologna
Robert Z. Lawrence, John F. Kennedy School of Government, Harvard University
Karin Lissakers, International Monetary Fund
Martin Mayer, The Brookings Institution
Dimitri B. Papadimitriou, Levy Institute
The Honorable Alice M. Rivlin, Board of Governors, Federal Reserve System
Eugene H. Rotberg, formerly of the World Bank
Walker Todd, Economic Consultant
Charles D. Toy, Overseas Private Investment Corporation
Lawrence Uhlick, Institute of International Bankers
L. Randall Wray, Levy Institute
Glenn Yago, Milken Institute
Yukio Yoshimura, International Monetary Fund

For more information and to register, see the What's New section of the Levy Institute web site (www.levy.org).

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Congressional Policy Briefing on the Asian Crisis

On March 11, 1998, the Levy Institute held a policy briefing in Washington, D.C., for members of Congress and their staff to discuss the debate on the U.S. quota to the IMF and implications for the United States of the present and future financial situation in Asia. Distinguished Scholar Wynne Godley and Visiting Senior Scholar Jan Kregel gave a presentation entitled "Levy Bulletin on the Real Effects of the Asian Crisis." The executive summary of the presentation follows. A textual summation of the presentation, with the charts that were an integral part of it, can be seen on the Levy Institute web site in the What's New section.

Congress is currently debating an appropriation of public funds to increase the U.S. quota in the International Monetary Fund. Attention has so far been focused on how the financial losses arising from the Asian crisis should be distributed and whether public monies should be used to reduce those losses.

Within Asia the principal manifestation of the crisis has been the spectacular collapse of exchange rates and stock market prices that spread rapidly through the region. In the United States, and in the more developed economies, the impact has thus far been inconsequential. Yet, there are reasons to believe that the full impact on American jobs and profits could eventually be substantial.

While the direct effect of the crisis on U.S. trade will probably not be large, a balanced assessment must take account of indirect effects working through trade linkages worldwide. Using a simple but quite comprehensive model of world trade and production, we generated estimates of the overall effects under a wide variety of assumptions. Solving the model mechanically, we concluded that the effect could be to reduce U.S. GDP by 1 percent this year, 2 percent in 1999, and even more thereafter.

The main thing we learned from this work, beyond gaining some sense of the magnitudes involved, is that the eventual scale of the impact is going to turn critically on the policy responses around the world. We are particularly concerned about the likely policy response in Western Europe, where there is a frantic scramble to maintain budget deficits below the 3 percent maximum required for entry into the EMU starting in 1999. There must also be serious doubt as to whether Japan, which stands to suffer more from the Asian crisis than any other country, will take adequate countervailing measures in a timely fashion.

Although the U.S. economy is still roaring ahead, the expansion may be more fragile than it appears. We argue that it has been the rise in private sector expenditure relative to income that has been the major force behind the expansion initiated in 1991. While history suggests that private expenditures can rise relative to income for an extended period, this cannot continue forever. The very existence of the private sector deficit implies that the sector as a whole has become a net borrower. This means that an increasing deficit can occur only as long as there is an increasing flow of voluntary net lending from the financial system, which, in turn, implies a continuing rise in the ratio of debt to income.

This brings us to the conclusion that it is not necessary for private expenditure to fall into order to bring the U.S. boom to an end. All that is necessary is that private expenditure stops rising relative to income. And this may come about as a result of a restriction in lending by financial institutions or as a result of a reduction in the rate of growth in incomes caused by the Asian crisis or as a result of losses incurred by banks on their Asian lending.

This is the domestic context in which the full impact of the Asian crisis on the U.S. economy should be considered. The timing of turning points in debt inflation and deflation is notoriously difficult to predict. We have learned from experience that turning points often occur as a result of completely unexpected shocks that initially appear to be inconsequential. So we must take seriously the possibility that the Asian crisis will turn out to be just that kind of shock.

The message that emerges from our estimates of the likely parameters of the impact of the Asian crisis on the economic performance of the United States is that even with the current IMF bailout of Asia, the return to growth and stability in these countries will require sustained expansion in the rest of the developed world. However, this will require positive policy measures to offset the restrictive effect of the required increase in Asian exports to the developed world.

If policy to sustain demand in the United States, Japan, and Europe is not implemented, the Asian recovery will not occur. And, even more importantly, the crisis can be expected to spread to South America and Eastern Europe. Even Japan might face financial instability similar to that witnessed in Korea. If the IMF is unable to respond to these events because of a lack of resources, the likely result could be a recession both wider and deeper than that now in prospect.

Given the size of the potential loss of income and employment that would follow from a global recession, it would be prudent, even if there is only a small probability that the recession will occur, for Congress to commit to the $18 billion to the IMF. Committing to the quota is not all that the United States can do to ensure the recovery of the Asian economies. It can also act to ensure that the Asian crisis does not bring its own expansion to an end. And it can urge its developed country allies to act toward the same end.

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Presentations and Publications by Levy Institute Scholars

Executive Director **Dimitri B. Papadimitriou** published "Employment Policy, Community Development, and the Underclass" (a version of Working Paper No. 220), in *Improving the Global Economy: Keynesianism and the Growth in Output and Employment*, edited by Paul Davidson and Jan A. Kregel (Elgar, 1997). "The Economic Contributions of Hyman Minsky: Varieties of Capitalism and Institutional Reform" (Working Paper No. 217) by Senior Scholar **L. Randall Wray** and Papadimitriou will be published in a forthcoming issue of the *Review of Political Economy*.

L. Randall Wray is also the author of "The Development and Reform of the Modern International Financial System," in *Post Keynesian Foundations in the Analysis of International Economics*, edited by Johan Deprez and John Harvey; "The Political Economy of the Current U.S. Financial Crisis," in an as yet untitled book edited by Philip Arestis and Malcolm Sawyer; "Money, Credit, and Finance" and, with Johan Deprez, "Monetary Theory of Production," in the *Encyclopedia of Political Economy*, edited by Philip O'Hara. Wray presented the papers "Zero Unemployment and Stable Prices" and "Money and Taxes: The Chartalist Approach" at the Allied Social Science Association meetings in Chicago in January and participated in two sessions, "Roundtable on Hyman Minsky" and "Roundtable on Government as Employer of Last Resort," at the Eastern Economic Association meeting in New York in February.

Senior Scholar **Joel Perlmann** contributed "Russian-Jewish Literacy in 1897: A Reanalysis of Russian Census and United States Immigration Data" to *Papers in Jewish Demography 1993: In Memory of U. O. Schemlz*, 1997. He presented "Intermarriage and Assimilation: The Long View of American Ethnicity and Race" at the annual meeting of the Eastern Sociological Society in Philadelphia in March. Perlmann will present a paper on intermarriage and multi-raciality at a meeting of the European Social Science History Association and will be a commentator at a meeting on second-generation transnationalism at the David Rockefeller Center for Latin American Studies of Harvard University.

Distinguished Scholar **Wynne Godley** gave a lecture entitled "The Real Effects of the Asian Crisis" at the New School for Social Research in February.

At the 1998 Eastern Economic Association meeting in New York in February, **Mathew Forstater** presented a paper entitled "Structure, Behavior, and Motivation"; chaired two sessions, "Roundtable on Full Employment" and "Economics and Virtue"; was a discussant in the session "Traverse"; and organized six sessions: "The Contributions of Hyman P. Minsky to Economic Policy," "European Monetary Union: Looking Forward to Post-1999," "Roundtable on Full Employment," "Deficits in Our Understanding," "Globalization and Stagnation," and "Alfred Schutz and Economics." Forstater's "Flexible Full Employment: Structural Implications of Discretionary Public Sector Employment" will appear in a forthcoming issue of the *Journal of Economic Issues* and "Working Backwards: Instrumental Analysis as a Policy Discovery Procedure" will appear in the *Review of Political Economy*.

Cambridge University Visiting Scholar **Stephanie Bell** presented the paper "The Role of the State and the Hierarchy of Money: Fiscal and Monetary Policy Implications of Paying Taxes in a Modern Economy" at the February meeting of the Eastern Economic Association.

Research Associate **Karl Widerquist** presented "An Efficiency Argument for the Guaranteed Income" and "A Voting Paradox and the Budget Deficit," was a discussant, and chaired a session at the February Eastern Economic Association meeting. He will present "Reciprocity and the Guaranteed Income" at the Pennsylvania Economic Association's annual meeting in Allentown in May.

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