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The 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.

Dimitri B. Papadimitriou, *President*

The *Summary* is a quarterly publication of The Levy Economics Institute of Bard College intended to keep the academic community informed about the Levy 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

To our readers:

This issue begins with a summary of the strategic analysis by Distinguished Scholar Wynne Godley and Research Scholar Alex Izurieta. They provide an explanation for the recent economic slowdown in the United States, examine policy options, and discuss alternative scenarios for medium-term economic performance that were generated using the Levy Institute Simulation Model. In a related policy note, Phillips & Drew economist Bill Martin forecasts a U.S. post-bubble trauma that will have global consequences. The results of these analyses will most likely be negatively affected by the disasters of September 11.

A new project has been launched to develop what will be called the Levy Institute Quality of Life Index, under the program on the distribution of income and wealth. The project is directed by Senior Scholar Edward N. Wolff, who has provided the Summary with a report. A working paper by Thomas I. Palley, assistant director of public policy at the AFL-CIO, is also summarized under this program. Palley presents evidence suggesting that persistent unemployment in the European Union is due mainly to faulty macroeconomic policies and not, as is sometimes argued, to rigid labor markets.

Two working papers are summarized in the program on financial markets and monetary policy. Visiting Scholar Jörg Bibow of the University of Hamburg examines the arguments for central bank independence and finds them both defective and risky. Research Scholar Alex Izurieta reports on the results obtained from a theoretical macroeconomic model, based on the same methodological principles as the Levy Institute Simulation Model, regarding the effects of external shocks on a country committed to a common currency regime. His findings suggest that a national government's ability to maintain socially desirable levels of economic growth and employment may be compromised under such a regime

In the program on federal budget policy, two policy notes by Visiting Senior Scholar L. Randall Wray of the University of Missouri, Kansas City, are summarized. In the first, Wray argues that policymakers' blind belief in the desirability of budget surpluses as an end in themselves is inhibiting U.S. fiscal policy. Holding such a belief in the face of the current slowdown and not implementing further fiscal expansion, he fears, will aggravate the slowdown. Wray examines the interim report submitted by the President's Commission to Strengthen Social Security in his second policy note. He finds the recommendations and conclusions unacceptable in light of the report's errors and omissions, and makes the case that the logic behind its arguments is, at best, dubious.

Research and activities previously included under special studies are now summarized under the heading of explorations in theory and empirical analysis. Two working papers are included here. Senior Scholar Joel Perlmann examines issues related to second-generation Americans. In the first of his two papers, he calls attention to shifts in the social composition of second-generation cohorts that have not been studied systematically before. In the second, he compares several indicators of the progress of second-generation Mexicans to those of other population groups, using data for the years between 1994 and 2000.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou
President

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Institute Research

Strategic Analysis

As the Implosion Begins... ? Prospects and Policies for the U.S. Economy: A Strategic View

Wynne Godley and Alex Izurieta
Strategic Analysis, July 2001

Economic growth in the United States has slowed down markedly this year. In fact, the second quarter's annualized growth rate was a mere 0.3 percent, suggesting virtual stagnation. Substantial and urgent changes in policies are required if the economy is to achieve an adequate growth rate in the near future. Monetary policy has already been on an appropriate expansionary path. However, according to Distinguished Scholar Wynne Godley and Research Scholar Alex Izurieta, it is also necessary to loosen fiscal policy further and adopt measures to redress the mounting balance of payment deficits.

Godley and Izurieta point out that growing budget surpluses and balance of payment deficits exerted a drag on aggregate demand during the boom. Under these conditions, aggregate demand could grow only because private expenditure (consumption and investment combined) exceeded, on an increasing scale, private disposable income (personal and corporate sectors combined). The growing private sector deficit was financed by increased borrowing and, to a much lesser extent, by foreign purchases of equities. Decomposing the private sector deficit into its corporate and personal components shows that the latter's debt burden, measured as the ratio of household debt to household disposable income, hit record levels during the boom.

It is important to note that the difference between private income and expenditure as defined by the authors is quite unlike saving as defined in the official national income accounts. Godley and Izurieta consider income gross of depreciation; by their definition, expenditure includes investment in fixed and working capital. The rationale for the chosen definition-best understood as a financial balance-is that a sector's expenditure can run above income only to the extent that the excess is borrowed, or the sector as a whole experiences a net realization of assets, or cash balances are run down. The argument made by the authors about the unsustainability of private deficit refers to this concept.

The official measure of saving rate seems to have deteriorated during the boom, but some have argued that this is a result of improper measurement. Analysts commonly assert that capital gains must be included in saving because they add to net worth; in light of the unprecedented boom in stock prices, such inclusion would dramatically lift the saving rate. While capital gains add to wealth, they can add to household spending only if households increase borrowing or realize the capital gains by selling assets. Godley and Izurieta argue that, ultimately, the limit on the growth in debt is set not by the debt-to-wealth ratio, but by the proportion of debt to income, because debts have to be serviced in cash. An attempt by the household sector as a whole to realize capital gains would, they say, likely result in a stock market collapse. Hence, capital gains cannot redress the problem of growing private deficit.

Rising balance of payments deficits and the resulting deterioration in net foreign asset position have not destabilized the economy as much as one would expect because net income from abroad has surprisingly remained close to zero. Closer analysis shows that net income from financial investments (net purchases of corporate and government bonds, equities, and foreign currencies) fell steadily during the boom, consistent with the fall in net foreign financial assets. However, net income from direct investments has remained steady (in fact, it rose in 2000), even though the net stock of direct investment has fallen from its level at the end of the 1980s. The authors argue that income flows associated with direct investments are hard to interpret because profits of entire companies are included irrespective of whether there were actual remittances. By contrast, flows associated with financial investments include interest and dividends actually paid across countries.

Godley and Izurieta examine the implications of the assumptions made by the Congressional Budget Office (CBO) in projecting taxes and revenue from 2001 to 2006. The CBO takes into account the 2001 tax bill, but assumes no further changes in policy and budget surpluses. The authors demonstrate that if the CBO's assumptions are fulfilled, the balance of payments deficit will worsen further to impose a substantial outflow of factor payments abroad. As regards the CBO's assumption about GDP growth, the projected budget surpluses and balance of payments deficit would require, purely as a matter of accounting, an astounding increase in private deficit. However, available evidence indicates that the credit boom is already coming to an end and the current level of private deficit itself is unsustainable.

Similar credit booms occurred in the United Kingdom, Finland, and Sweden during the 1980s. The reduction in private sector deficits that accompanied the collapse of these booms resulted in substantial losses in output growth and painful increases in unemployment. If a similar process unfolds in the United States, say the authors, and private financial balance returns gradually to its normal positive level over the next five years, average output growth will be roughly 1 percent and unemployment will rise to 9 percent by 2006. Even if the gap between private expenditure and income were to be merely closed, output growth would not exceed 1.63 percent and unemployment would still rise to 8.2 percent.

To avoid the undesirable consequences stemming from an elimination of the private deficit, an enormous fiscal stimulus is required, amounting to roughly $700 billion (in 2001 dollars). While such a stimulus may help to maintain current low levels of unemployment, it will not, by itself, enable balanced and sustainable growth. A huge fiscal expansion will worsen the balance of payments deficit substantially unless net exports rise significantly, something that can come about only as a result of dollar devaluation or by concerted international efforts to reflate the rest of the world. Unfortunately, according to Godley and Izurieta, both paths appear to be unavailable at present, placing policymakers and the U.S. economy in an extremely difficult position.

The New Old Economy
Bill Martin
Policy Note 2001/7, May 2001

The consensus view, in spite of the synchronous slowdown of the world's economies, is that the U.S. economy will continue to grow at a rate of about 3 percent per year with low unemployment. Bill Martin, chief economist at Phillips & Drew, the London-based member of UBS Asset Management, takes exception to this view and forecasts that the American economy is headed for a hard landing that includes a prolonged period of anemic growth accompanied by a substantial loss of jobs. Furthermore, the fallout from the U.S. economy will be global.

Martin bases his forecast on the unusual nature of the American expansion during the 1990s. At that time, there was a profound shift from the norm in spending behavior (private spending over income had reached 6 percent of GDP versus a long term average of 2.5 percent) as a result of a liberalized financial system that raised expectations and reduced risk assessments in an atmosphere of technological innovation and productivity improvements. Martin maintains that the New Economy can neither justify nor sustain this remarkable shift in consumer behavior, and that in order to increase current levels of demand, there would have to be further increases in private spending relative to income. He also notes that productivity improvements were actually higher in the 1960s when consumer behavior was "normal." In addition, Martin suggests that the economy's unusual stability in the 1990s was something of a fluke since its business cycle was decoupled from that of Europe and Japan as a result of peculiar events in those areas of the world. Today, however, forces are in place that are again fostering synchronization.

Noting that the longer the boom and excess borrowing persisted, the more vulnerable the economy, and the bigger the boom, the bigger the bust, Martin expects the U.S. economy to experience the post-bubble trauma associated with a prolonged period of excessive exuberance and borrowing.

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Program: Distribution of Income and Wealth

Project Summary: Quality of Life
Edward N. Wolff, Senior Scholar and Project Director

The United States has expanded its lead over other advanced industrialized nations in terms of conventionally measured per capita income. However, it is not clear that welfare levels in the United States have grown concomitantly with per capita income. It is also not clear that people in different regions of the country have benefited equally from the growth in income and welfare levels, or that Americans are necessarily better off than the citizens of other advanced countries.

The quality of life (QOL) project will investigate two issues in detail. First, how much has welfare increased in the United States over the past century, particularly over the postwar period? Second, what kind of economic system is "delivering the goods" in terms of raising welfare along with per capita income?

With regard to the latter issue, there appear to be three leading post-Soviet era models. The free enterprise model, exemplified by the United States, provides minimal government intervention

or support of low- and middle-income residents. The European social welfare state, by contrast, heavily subsidizes public consumption and makes extensive public transfers to both the poor and the middle class. In the paternalistic corporate system, exemplified by Japan, the company provides many of the social supports that in the European model are the prerogative of the state.

A rigorous examination of conventional and more inclusive measures of living standards is necessary to confront these questions. We intend to develop and publish at regular intervals an index for the regions of the United States, the country as a whole, and a few member countries of the Organization for Economic Cooperation and Development (OECD). This Levy Institute Quality of Life Index will concentrate on economic aspects of well-being; particular attention will be paid to factors that can be converted into money equivalents. It will provide information by quintile of income distribution, as opposed to most of the similar indicators available today, which have been constructed for the total population or at the mean. A select group of social scientists and policymakers will provide overall guidance in the index's construction.

The project was preceded by a conference at the Levy Institute in June 2001 entitled "What Has Happened to the Quality of Life in America and Other Advanced Industrialized Nations?" (*Editor's Note:* Summaries of the sessions and a speech made at the conference are available in the Summer 2001 *Summary* .) At the conference, leading researchers in the field presented both conceptual and empirical papers identifying some of the key issues connected to measuring and evaluating the standard of living. The papers were not intended to be major research projects in themselves. Instead, they were meant to identify the major issues and provide some empirical estimates of their importance. The authors, invited from several countries and around the United States, drew on their own past research or that of other economists. A conference volume from this meeting is currently in preparation.

On the basis of the papers presented at the June conference, seven areas have been identified for further research. They are:

1. *Standard and more comprehensive measures of income.* The standard measure of family income-as found in, for example, the Current Population Survey-is pretax cash income. We want to construct a more adequate measure of disposable income. This would entail subtracting personal income, social security, and taxes not related to income; adding in non-cash government benefits such as Medicaid and Medicare; including imputed rent under the category of owner-occupied housing; adding in capital gains; and so on. The Census Bureau routinely applies a series of adjustments to the basic income concept to obtain a more comprehensive measure of income, and we intend to follow this methodology. Moreover, it is necessary to adjust total family income for different family sizes using an equivalence scale. There is already an extensive literature on this subject.

2. *Consumption-based measures of economic well-being.* Work by Christopher Jencks and Susan Mayer, David Johnson, and Daniel Slesnick, among others, suggests that trends in consumption and the distribution of consumption differ markedly from those of standard measures of income. Almost all of the work to date has looked at the implications of using consumption data for measuring poverty. We intend to apply similar methodologies to real consumption trends at different points of the income distribution.

3. *The incorporation of government expenditures on social welfare into measures of living standards.* Standard measures of family income already include cash government benefits such as social security and welfare. In part (1) above, we intend to extend this concept to include noncash government transfers such as food stamps and Medicare. However, the government also provides benefits to families in the form of educational, highway, safety, water, sewerage, and other expenditures. Our work will rely on recent research by [University of Texas doctoral student] Anindita Sen, who has made a range of imputations for various government expenditures at different decile levels of the income distribution.

4. *The incorporation of wealth into indicators of well-being.* Conventional measures of living standards rely exclusively on flow data-either income or consumption. However, the ownership of assets also provides benefits to families. Some of these benefits are direct, such as those from homes and consumer durables, which provide consumption services to households. However, financial assets also provide security to families, as well as potential future income flows. Several papers have already explored ways of incorporating wealth into more comprehensive measures of well-being.

5. *Changes in leisure time and household production.* Leisure time is another element of well-being that is absent from standard income measures. Indeed, there is often a tradeoff between greater cash income and more leisure time. Leisure time is also a source of another substitute for cash income-namely, household production. Services that can be obtained in the marketplace (e.g., cooking, child care, home repair) can often be substituted for by work in the home. There is an extensive literature on how to measure household production, which, according to some estimates, accounts for as much as 50 percent of standard GDP measures.

6. *Trends in job satisfaction, fringe benefits, and perquisites.* Work can be a source of utility or disutility to individuals. Several recent studies have tracked trends in job satisfaction in the United States. Jobs also provide a type of income that is not picked up in conventional income measures: fringe benefits, which may include pension contributions, health care insurance, vacation time and pay, and so on. The Current Population Survey's occasional special sections on fringe benefits can be used to construct more comprehensive measures of family income. Special perquisites given to high-level employees-such as a company car, expense account, or company-provided housing-would also be a desirable addition to our index.

7. *Health status and environmental issues.* We are considering including additional information in the QOL index on the healths of the population and the environment. With regard to the latter, an extensive literature exists on measuring "Green GDP," though such measures have been aggregate in nature. We will consider ways of distributing gains and losses from changes in environmental status on household well-being.

Annual meetings will be held for scholars engaged in the above areas of research and papers presented will be published in book form.

We will incorporate relevant advances in methodology and data into the construction of the Levy Institute QOL Index. It is our hope that analysis of the index's findings at regular intervals will show progress or lack thereof in economic well-being in the various regions of the United States, the country as a whole, and some member countries of the OECD, and will therefore serve as a valuable tool in the making of public policy.

The Role of Institutions and Policies in Creating High European Unemployment: The Evidence

Thomas I. Palley
Working Paper No. 336, August 2001

As of September 2000, the unemployment rate in the European Union was 8.3 percent, as compared to 3.9 percent in the United States. One view attributes this divergence in performance to Europe's rigid labor markets; U.S. labor markets are, by contrast, flexible and dynamic. The opposite view claims that Europe's problem is a result of austere macroeconomic policies aimed at reducing inflation regardless of the unemployment cost, the underlying cause of inflation, or the state of the business cycle; U.S. macroeconomic policy, on the other hand, is considered relatively flexible and countercyclical.

Thomas I. Palley, assistant director of public policy at the AFL-CIO, provides new evidence to assess the relative merits of the two views. He made use of an empirical model of unemployment that includes annual macroeconomic and microeconomic variables describing labor market institutions for 20 countries. For each type of institution in each country, a six-year average measure was constructed covering the periods 1983-88 and 1989-94. Palley's model included variables to capture the cross-country Keynesian multiplier effects that operate via international trade within the European economy and, for Canada, via trade with the United States.

While conventional wisdom concerning the causes of high European unemployment focuses on excessive employment protection, generous replacement rates, long benefit durations, and high rates of unionization, the empirical results of Palley's study challenge this view. Benefit duration and the level of union density are both consistently insignificant, as are some other microeconomic variables (employment protection, replacement rate, and tax burden). However, other labor market institutions do matter. Wage bargaining coordination, which lowers unemployment, and the extent of union coverage, which raises unemployment, matter consistently, but need not raise unemployment if they are appropriately paired. In addition, while higher tax rates raise unemployment, a more cost effective fiscal approach to lowering unemployment is to increase spending on active labor market policies.

The effects of macroeconomic policy are captured by changes in the inflation rate, the level of real interest rate, and the real GDP growth rate. Economic openness variables, such as the exposure of individual countries to intra-European and international trade, are considered especially important for macroeconomic performance. Consistent with the conventional understanding of the impact of macroeconomic policy, the analysis shows that falling inflation rates (disinflation) and higher real interest rates raise unemployment while faster growth lowers it. Disinflation and higher real interest rates in Europe vis-à-vis the United States are indicative of the more difficult macroeconomic conditions confronting European economies. Palley notes that real interest rates have tended to be systematically higher in countries with higher union density despite the lack of evidence that high union density raises inflation. This suggests that central banks have systematically raised interest rates in countries with high union density consistent with the idea that monetary policy is a site of class conflict. Currency market concerns also played an adverse role, along with the introduction of the euro as countries were forced to satisfy strict fiscal convergence criteria.

Palley's study shows that the decline in the U.S. unemployment rate is attributable to positive macroeconomic forces, such as low real interest rates and robust GDP growth, while almost all the rise in European unemployment can be attributed to negative macroeconomic forces, such as falling inflation rates, high real interest rates, and slower growth generated by government policies. Therefore, argues Palley, Europe should adopt expansionary macroeconomic policies predicated on lower real interest rates and adopt rules that ensure that monetary and fiscal policies move in countercyclical fashion. Moreover, labor market institutions protecting workers in Europe have resulted in relatively unchanged income inequality, while the erosion of labor market institutions in the United States has increased income inequality. Therefore, the ideal is an expansionary macroeconomic policy combined with labor market institutions that protect workers' voice and bargaining power.

It is unlikely that the current policy regime in Europe can accomplish this urgently needed shift in policy stance. Their inertia is exemplified by the different policy responses to the economic slowdown of 2001: the European Central Bank lowered interest rates by a mere 0.25 percentage point in the first six months of the year, while the Federal Reserve slashed them by 2.75 percentage points. Palley asserts that his results are damaging to the Washington Consensus approach to the problems of economic growth in developing countries that focus on policies related to labor market flexibility.

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Program: Financial Markets and Monetary Policy

Reflections on the Current Fashion for Central Bank Independence

Jörg Bibow
Working Paper No. 334, July 2001

The currently fashionable viewpoint is that a monetary structure that maximizes central bank independence is most likely to improve the efficient conduct of policy. This viewpoint is fostered by the time-inconsistency literature, which argues that a monetary structure that incorporates "discretion" causes an inflationary bias remediable by central bank independence. Visiting Scholar Jörg Bibow of the University of Hamburg takes exception with this viewpoint; its proponents, he says, lack a credible theory of monetary policy and inflation. As a result, he concludes, the alleged time-inconsistency problem does not provide a convincing case for central bank independence. Instead, he recommends a more balanced and symmetric approach to the subject.

Bibow's analysis includes developing a conceptual framework for analyzing central bank independence in a rules and discretion context, revisiting the views of Keynes and Friedman on these issues, and critically reviewing the modern time-inconsistency literature, widely believed to have settled the case for rules rather than discretion. Since the latter dichotomy in monetary policy is not clear-cut, Bibow views its framework as a continuum where the extent of any discretion left in any monetary arrangement is determined by the nature and precision of the targeted variable(s), the immediacy of the link between policy actions and the attainment of the targeted variable(s), and the transparency of the policy strategy.

Bibow notes that all policy rules under discussion today are feedback rules (rather than fixed rules), which involve mechanisms that link authorities' reactions to changes in particular variables, but include genuine flexibility. The current policy instrument is the short-term interest rate, which affects output and inflation with long and variable lags. Conduct of policy is distinct from the structure of monetary policy, and the central issue is the delegation of some aspects of responsibility for monetary policy to an independent agent. Bibow surmises that central bank independence may come in various forms and degrees, of which maximizing independence may not be the most efficient.

The traditional rules-versus-discretion debate is captured by the views of Keynes and Friedman. Keynes favored a democratic version of an independent central bank based on checks and balances. The central bank would be in control of the policy instrument and decide the policy stance. The government would have the prerogative to lay down the policy goals. The central bank's discretion would be constrained by stringent transparency requirements and its performance held to account by the government. Friedman, on the other hand, categorically rejected central bank independence of any form or degree in light of the dispersal of responsibilities for monetary and fiscal policies, the lack of overall accountability, and the potential impact of central bank personalities. His proposed "k-percent rule," a fixed growth rate for the money supply, attempted to neutralize the central bank and leave the authorities, whom he deemed the source of uncertainty, with zero discretion. In effect, Friedman favored an extreme set of checks and balances to protect the money supply from anyone's discretion, by law.

In his review of competing explanations of the observed inflationary bias, Bibow notes that the time-inconsistency explanation for inflation, including the relationship between inflation and unemployment, is an alternative to traditional Keynesian and monetarist explanations. The time-inconsistency explanation of any inflationary bias stresses the role of structure rather than the conduct of monetary policy. According to the underlying assumptions about the interplay between the public (labor-market participants) and policymaker, and the latter's postulated inclination to push unemployment below the natural rate, the optimal zero inflation policy was deemed to be time-inconsistent. An inflationary bias was believed to be inherent in any monetary structure incorporating discretion. This setup presumes that the policymaker has not only the incentive but also the means to spring inflation surprises upon the public.

Bibow contends that the meanings of "rule" and "discretion" have fundamentally changed. When the usefulness of discretion was rediscovered, the notion of rule was simply redefined and got the credit. Moreover, he notes, the key parameters in the time-inconsistency explanation explain a constant equilibrium inflation bias but no sustained acceleration or deceleration of inflation. Further review of the literature relating to proposed solutions leads Bibow to conclude that it does not represent any real problem in formulating monetary policy and would be a nonissue in a rational expectations framework that takes proper account of policy lags. Many paradoxes exist in this area, such as the presumption that independent central banks, e.g., the Bundesbank, can do no wrong; and Germany's peculiar combination of record low inflation, an independent central bank, and an exceptionally high sacrifice ratio in terms of output and unemployment. Therefore, Bibow concludes, the time-inconsistency theme offers a pseudosolution to a nonexistent problem. While promising a free lunch, the literature on the subject has encouraged a biased, dangerously onesided approach to central bank independence that completely overlooks the risks involved when maximizing their discretion.

Can Countries under a Common Currency Conduct Their Own Fiscal Policies?

Alex Izurieta
Working Paper No. 337, August 2001

Several major economies in the developed and developing world are now operating under common currency arrangements, such as the Economic and Monetary Union in Europe and dollarization in Argentina. Conventional wisdom, as expressed by the Washington Consensus and the European Central Bank, holds that these arrangements will eventually bring about faster economic growth and higher levels of prosperity, although they might involve short-run losses in growth and employment. Other experts, however, have argued that the vision of a rosy future under a common currency rests on the unwarranted assumption that market economies can achieve efficiency and equity without policy interventions. A common currency regime deprives a nation of direct control over all major tools of macroeconomic policy-exchange rate, money supply, and fiscal maneuvering. Consequently, in the absence of a supranational agency committed to ensuring balanced growth among countries, the regime will aggravate regional disparities in economic development. In this working paper, Research Scholar Alex Izurieta develops a macroeconomic model of a common currency region and uses it to assess the impact of external shocks on individual countries under different fiscal responses.

The author makes use of a stock-flow model that rests on several assumptions: there are only two countries ("North" and "South"), which trade only with each other; bonds issued by the two national governments are the only financial assets; and commercial banks are absent, so that financing takes place directly between households, firms, government, and the common central bank. As for behavioral relations, consumption is considered to depend on current disposable income and inherited wealth (consisting here only of the stock of government bonds). Household disposable income and government budget deficits are defined so as to include capital gains or losses. Household demand for "high-powered" money issued by the central bank is specified to be a constant fraction of total wealth, while their demand for government bonds depends on relative rates of return. Apart from high-powered money, the only other liability of the central bank is the total foreign exchange reserves (a fixed amount in this model due to the assumption of a closed economy) deposited by the two governments. On the asset side, the central bank has the loans that it advances to the governments. However, the amount a government can borrow from the central bank is constrained by its foreign exchange reserves. Consequently, the ultimate limit to a government's capacity to finance a deficit arises from its ability to borrow from the private sector at market-determined interest rates.

The behavior of the model is studied via computer simulation. In the steady state, output, money, income, and wealth remain constant. An external shock to North in the form of a one-time reduction in South's import propensity has a destabilizing effect. North's balance of payments runs into deficit as a result of a decline in exports and growing interest payments to South. (The latter comes about because once a government runs down its foreign exchange reserves with the central bank, the only way a trade deficit can be covered is by selling government bonds to households in the other nation.) Similarly, government budget deficits that emerge initially because of a reduction in tax revenues-the result of a fall in income generated by the decline in exports-eventually force the government to borrow from its citizens by issuing new bonds. The pressure to sell more bonds on account of growing balance of payments and budget deficits forces an increase in interest rates in North.

Izurieta also examines the effects of the same one-time drop in South's import propensity on North when there is a requirement that North's government budget must always be balanced. As opposed to the situation when there is no such constraint, there will eventually be no deficit in North's balance of payments because the trade deficit will be closed by reductions in income and imports. However, the absence of deficits in the government budget and on the external front is accompanied by sustained reductions in output and employment in North. Strikingly, this is not compensated by output and employment gains in the South, so that the common currency region as a whole suffers losses.

According to Izurieta, the analysis sheds serious doubts on the desirability of common currency arrangements. If a country adopts such an arrangement and if it faces an external shock it will be forced to run persistent deficits in its government budget to avoid a painful recession. In addition, if it enters into such an arrangement by accepting limits on budget deficits, the country will be forced to face serious losses in output and employment. Therefore, concludes Izurieta, countries are well-advised to keep out of common currency arrangements as currently envisaged.

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Program: Federal Budget Policy

The Backward Art of Tax Cutting
L. Randall Wray
Policy Note 2001/5

The Economic Growth and Tax Relief Reconciliation Act passed by Congress will provide roughly $1.3 trillion in tax relief over the next decade. Two separate issues have arisen as a result of this action-the size and scope of the necessary tax cut, and the tenuous nature of long-term projections of the budget surplus. Critics suggest that President Bush's plan risks a return to chronic budget deficits and a weakened government capacity to meet future spending requirements. As a result, future tax cuts should be tied to the size of the surplus according to "triggers." L. Randall Wray, Visiting Senior Scholar, rejects this notion and concludes that tax cuts should not be based on budget surpluses, but rather on a fiscal stance that is appropriate to economic performance. When an economy falters, Wray contends, it is desirable for the budget to move toward deficit. His argument for immediate further tax relief in excess of the Act is based upon the relationship among economic growth, the federal budget, and the U.S. trade account; the elimination of fiscal drag incorporated in current budget policy; and the case of Japan. Thus, he says, triggers should operate in a reverse manner, generating larger tax cuts as a slowing economy destroys fiscal revenues.

Although evidence on economic growth, corporate earnings, inventories, employment, and equity values suggests that the United States is sliding toward recession, Wray believes that this may not materialize in 2001. GDP may rebound in the second half of the year if the Federal Reserve continues to reduce interest rates and the private sector continues to accumulate larger debt. Since the nature of the past expansion was unprecedented and fueled by record deficit spending by the private sector, Wray expects that the depth of the coming recession will in part be functionally related to the length and height of the expansion. Lower interest rates and additional consumer spending may postpone the day of reckoning, but this is a temporary solution that will only make the eventual hard landing worse.

Wray notes that at even small rates of GDP growth, the federal budget surplus is expected to rise to 5.2 percent of GDP by 2011, according to the Congressional Budget Office (CBO) projection. If the United States achieved balanced trade, and state and local governments balanced their budgets, the private sector would have to run an overall deficit equivalent to the budget surplus in order to maintain moderate economic growth. This is unlikely given that normally, short-lived private sector deficits occur during robust expansions and are followed by a return to surpluses. Given the projected federal budget imbalance, personal saving would have to grow increasingly negative over the next decade in order to keep aggregate demand high enough for the economy to grow. Since it is irresponsible to formulate budget policy on the assumption that Americans will continue to spend in excess of their incomes for the foreseeable future, Wray contends that a very large, permanent adjustment must be made to the fiscal stance to eliminate the fiscal drag incorporated in current budget policy. The objective is to eliminate future surpluses without inducing a recession that would destroy private sector income and wealth and tax revenues. The likelihood of continuing trade deficits implies that the size of the required fiscal adjustment may be as high as 4.5 percent of GDP ($450 billion annually). Thus, Wray contends that the legislated tax reform provides, at most, one-third or as little as 20 percent of the fiscal adjustment that will eventually be needed, and that the current tax relief package should be supplemented by another $200 billion in payroll tax cuts targeted at the bottom three-fourths of the population.

Wray outlines the case of Japan in order to illuminate the likely course of events without a substantial and immediate fiscal adjustment (a combination of tax cuts and spending increases). When that nation's economy collapsed, surpluses continued for a few years until fiscal restrictions pulled the economy down further. The budget was characterized by huge deficits (8 percent of GDP) because the sluggish economy reduced tax revenues in a cyclical manner. This was followed by reduced consumption and high household saving rates for the next decade as Japanese consumers lost faith in their economy. Wray notes that the U.S. position is not as perilous since much higher investment rates in Japan led to massive overcapacity, U.S. consumers do not save at the same high rate as Japanese consumers, and the United States has a more dynamic economy (younger population, greater immigration, lower labor costs, and fewer trade barriers). On the other hand, Wray adds, contrary to the Japanese case, the United States runs a trade deficit that contributes to the deterioration of the private sector's financial balance, the U.S. consumer would enter the recession heavily indebted, and potentially higher unemployment rates would generate widespread defaults on debt. In view of Japan's consumption tax hike in 1998 that killed a weak recovery, Wray calls for wiser U.S. government policy and a large, quick fiscal adjustment to soften the coming economic landing.

Killing Social Security Softly with Faux Kindness
L. Randall Wray
Policy Note 2001/6

Today, 5 percent of GDP is devoted to Social Security benefits and three workers support each retiree. In the future, these numbers are expected to be 7 percent of GDP and two workers per retiree, which implies that revenues will fall short of payments. In July 2001, the President's Commission to Strengthen Social Security approved a draft interim report that recommended a restructuring of the existing Social Security system. In essence, the report argues that the main defect of the current program is that it relies on the continued goodwill of Congress and future politicians may not support it. As a result, when Social Security revenues fall short of promised benefit payments, the lack of legal ownership is a source of insecurity. It should be replaced, said the report, by individual retirement accounts "owned" by the beneficiaries so that Congress cannot refuse payment. According to the commission, this measure would not amount to privatization.

Visiting Senior Scholar L. Randall Wray takes exception to the recommendations and conclusions of the commission's report in light of its errors, omissions, and doubtful logic. He points out that Social Security payments come from the Department of the Treasury, which does not, despite widespread belief to the contrary, use its own revenues to pay benefits. While he acknowledges that the program's payroll tax revenues may fall short of program spending by 2016, and that rapid growth will only postpone the day of reckoning and not resolve the problem, Wray believes that legal ownership is really privatization, which would create insecurity since individuals would be vulnerable to the fate of financial markets.

The central issue is the real burden of providing for future retirees. This burden will rise even if Social Security in its present form is retired. The solution, according to the commission, is for workers to save and invest more in order to increase future productivity by providing funds directly to the capital markets. Wray does not believe that a privatized retirement system will encourage individual investments in capital because the fundamental principle of portfolio management recommends low-risk and liquid investments prior to putting funds into higher-risk, illiquid investments. Private pension funds presume that Social Security provides a safety net for almost all retirees. Without this safety net, prudent fund managers would have to adopt far safer positions.

Although the commission correctly recognizes that too many Americans have insufficient savings or financial wealth, Wray believes that the source of the problem is not the Social Security program, but the growing inequality of income and the deterioration of opportunities for advancement. Therefore, Wray recommends that the commission redirect its efforts toward increasing the supply of good jobs, expanding educational opportunities, raising minimum wages, providing universal health care coverage, and widening the social safety net in order to promote individual security.

Wray maintains that Social Security is a social assurance program that helps to bring the majority of elderly persons above the poverty line. As a result, it should be retained, since it is a good deal for disadvantaged groups (as opposed to the commission's claim that it does not benefit women and minorities). Whereas the commission projects that increasing Social Security payments by an additional 2 percent of GDP would increase the payroll tax rate imposed on the current tax base by 37 percent, Wray estimates that the Social Security tax rate could actually drop from 12.4 percent to 6.7 percent if the tax base included all national income. Ultimately, Wray believes, the current program will continue to be supported by the growing elderly population and will remain intact.

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Explorations in Theory and Empirical Analysis

Toward a Population History of the Second Generation: Birth Cohorts of Southern- , Central- , and Eastern-European Origins, 1871-1970
Joel Perlmann
Working Paper No. 333, June 2001

One main objective of studying historical immigration data is to create some sort of benchmark by which to assess the nature and pace of socioeconomic progress in contemporary second-generation patterns. However, the inadequacy of historical data, one result of an imperfect statistical record, makes past-present comparisons problematic. By exploiting the Integrated Public Use Microdata Samples (IPUMS), huge national samples from the manuscript schedules of 19th- and 20th-century decennial censuses, Senior Scholar Joel Perlmann defines and derives basic numerical parameters of the second generation. His analysis of the compositional changes of second-generation cohorts confirms some of the fundamental conclusions of similar previous studies.

Perlmann's analysis uses a three-step process wherein he defines the older second-generation groups and the timing and magnitude of each ethnic cohort and outlines shifts in the social composition of second-generation cohorts. Because of inconsistencies in the database over time, he suggests that the annual published information about immigrants by country of origin and by "race or people" is better for studying ethnic group changes than for social class mobility. The study is limited to southern-, central-, and eastern-European (SCE) immigrants because of their predominance during the baseline period of significant immigration (1890-1920), the fact that they were not stigmatized, and because their ethnic data were more detailed and flexible than those of other groups. Perlmann notes that second-generation studies by cohort should be undertaken in the context of historical conditions and theoretical guidelines, including the

demographic impact of remigration. He defined young second-generation members (0-9 years) from the IPUMS dataset for the period 1891-1940 according to five-year birth cohorts and whether they were of foreign or mixed parentage. The sample size was then inflated to estimate population size for each cohort and corrected for mortality. The pattern of immigration was deemed to be important because children of later arrivals differed from those of earlier arrivals as a result of different social circumstances and a different process of incorporation into American society. Late arrivals could, in addition, profit from the connections of the early arrivals, and their spouses were more likely to be native-born.

Previous studies had not considered the implications of changing cohort composition. Changes from one cohort to the next were thought to result from differences in historical periods rather than in the cohorts themselves. Conducting an analysis similar to Stanley Lieberson's work with ethnic cohorts in *A Piece of the Pie* (1980) and with the help of the 1960 IPUMS, Perlmann found that, as expected, the mean educational attainment of the native-born of mixed parentage exceeded that of the native-born of foreign parentage. In each of the 12 comparisons of the SCE group and blacks, the net difference favored the SCE group more when the native-born of mixed parentage were included. Moreover, the improvement in the SCE advantage over time was actually greater among males and almost unchanged among females when the comparison was limited to the native-born of foreign parentage. Thus, the Lieberson conclusions hold up despite the changing proportion of mixed-parentage members in the cohorts.

Young Mexican Americans, Blacks, and Whites in Recent Years: Schooling and Teen Motherhood as Indicators of Strengths and Risks
Joel Perlmann
Working Paper No. 335, August 2001

The pattern of early immigration shows a slow but steady ascent in the socioeconomic status of successive generations. The net result is that there is little difference today in the socioeconomic position of the descendants of those who arrived in the various waves of immigration. The theory of segmented assimilation expresses concern about today's immigrants and the ability of those at the bottom of society to assimilate and improve their standards of living relative to the pattern of past eras. Based on the monthly Current Population Survey (CPS) by the United States Census Bureau for the period 1994-2000, Senior Scholar Joel Perlmann's study focuses on immigrant Mexicans, today's largest immigrant group entering American society at the bottom. His study identifies two emerging trends that reflect traditional immigrant processes: a high proportion of second-generation Mexican men are entering the labor force rather than pursuing higher education, and the Mexican second generation does not exhibit dysfunctional social patterns to the same extent as blacks of the same birth cohort.

Perlmann bases his analysis on such indicators as educational progress, young motherhood and marital status, and poverty and employment status. He isolates a sample of the Mexican second generation by considering native-born individuals reporting both parents born in Mexico. He compares this sample with data for descendants of earlier Mexican immigrants as well as data for native-born blacks and whites of the same cohort. The analysis is conducted for the nation as a whole and for central cities of metropolitan areas.

Educational attainment is measured in terms of graduation from high school (age 19-24 cohort) and mean educational attainment (age 25-34 cohort). Comparisons with the earlier Mexican generation are made by way of those in the 50-64 age cohort. The data highlight the great educational handicap of the immigrant generation compared to the native-born. They also show that second-generation Mexicans have not caught up with native black or native white populations. However, this latter observation is similar to those made about second-generation European immigrant groups a century ago; therefore, Perlmann reasons that the data do not necessarily imply a divergence from the traditional process of immigration.

In terms of educational attainment and mean years of schooling, improvement between young third-and-later-generation Mexican Americans relative to the second generation is small compared to improvement between the second and first generations. Perlmann believes that this smaller relative improvement is inconsequential because it compares young adults born in the same year, which, by definition, cannot be understood as an accurate comparison of a generation of children and their parents. Moreover, because historical developments matter, the third generation of an earlier trajectory cannot be seen as a good predictor of tomorrow's third generation. For example, previous immigrants had much less education than do today's. Therefore, it would be a mistake to base future educational attainments by generation and cohort on today's generation and cohort; claims that third-generation progress is stalling, based on data representing current cohorts, should be rejected. Perlmann expects the third generation to exceed the second in educational attainment by more than the comparison of current generations by cohort would suggest.

In patterns of childbearing and family formation, the study shows that the Mexican American pattern is closer to the white than to the black pattern. In addition, geographic locale does not alter the ethnic differences as much as expected.

Poverty rates do not suggest that second-generation Mexican development parallels that of blacks or imply radically slower economic improvement than for Mexican immigrants in the early 20th century. In terms of male employment, the Mexican pattern is closer to that of whites than of blacks, and resembles the older immigrant pattern where the focus was on entering the labor force rather than extended schooling. Except for the first generation, the proportion of women working full-time does not vary much across the ethnic groups, and in all three groups, more women than men reached college.

Perlmann notes the relatively low male-to-female ratio for black young adults and suggests that the data may overstate the progress of blacks generally. He recommends further study of the historical record to determine how past generations moved forward, and an analysis of how the economy will sustain subpopulations in which less than one-third of the native-born reach college.

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Institute News

New Scholars

Visiting Scholar **Qiyu Tu** is a Visiting Fulbright Scholar who joins the Levy Institute via Bard College's Bard In China Program. Tu is an associate professor and assistant director of the Institute of World Economy at the Shanghai Academy of Social Sciences. He also has been a Friedrich Ebert Foundation Visiting Scholar at the Hamburg Institute for Economic Research; Harvard-Yenching Visiting Fellow with the economics department at Harvard University; and visiting professor and governmental guest at the School of International and Area Study at Seoul National University. While conducting research at the Institute, he also will be teaching a course at the college in the East Asian economies. Tu received a Ph.D. in economics from the Shanghai Academy of Social Sciences.

W. Ray Towle has joined the Levy Institute as a resident research associate. He will serve as an editor for the *Summary* and other Institute publications. Towle recently worked as a consultant, writer, and editor in Canada and New York, and has an extensive background as an energy economist. He completed B.S. and M.A. degrees at the University of Alberta and received a Ph.D. in regional economic geography from the University of London. In his dissertation, Towle studied the social and economic impact of the electroindustry in Norway using input-output analysis of the national accounts. Recently, Towle completed an executive master of science in finance degree from the Zicklin School of Business at Baruch College, City University of New York. He is interested in research on macroeconomic forecasting, sustainable development, international financial systems, regional economic development, and deregulation.

The Institute wishes to welcome **Yuval Elmelech** as a research associate. Elmelech's current areas of research interest are social stratification, the distribution of wealth, and issues related to poverty, housing, race, and immigration. His publications include "Migration and Housing in Israel: Another Look at Ethnic Inequality" (with N. Lewin-Epstein). *Megamot: Behavioral Sciences Quarterly* 39:3 (1998); "Ethnic Inequality in Home Ownership and the Value of Housing: The Case of Immigrants in Israel" (with N. Lewin-Epstein and M. Semyonov). *Social Forces* 75:4 (1997); and "Educating Lena: Women Immigrants and 'Integration' Policies in Israel-The Politics of Reproduction and Family Planning" (with D. Amir and L. I. Remennick). In N. Lewin-Epstein, Y. Ro'i, and P. Ritterband, eds. *Russian Jews on Three Continents.* London: Frank Cass, 1997. Elmelech received an M.A. in sociology and anthropology from Tel Aviv University and is a Ph.D. candidate in sociology at Columbia University.

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Publications and Presentations by Levy Institute Scholars

Philip Arestis Visiting Senior Scholar
Publications: "The Economic Analysis Underlying the 'Third Way'" (with Malcolm C. Sawyer). *New Political Economy* 6:3 (2001); "Financial Liberalisation and the Globalisation of Financial Services: Two Lessons from the East Asian Experience" (with P. O. Demetriades and B. Fattouh), in S. Lahiri, ed., *Regionalism and Globalization: Theory and Practice* . Contemporary Economic Policy Issues Series. New York: Routledge, 2001; "Bernard Corry: Obituary." *Royal Economic Society Newsletter* , April 2001.
Presentations: "The Impact of Financial Liberalisation Policies on Financial Development: Evidence from Developing Economies" (with P. O. Demetriades, B. Fattouh, and K. Mouratidis), Maxwell Fry Memorial Conference, London, May 11; "The Euro and the EMU: Lessons for Mercosur" (with F. Ferrari, L. F. de Paula and Malcolm C. Sawyer), Towards Macroeconomic Convergence in Mercosur, St. Antony's College, Oxford, June 12.

Walter M. Cadette Senior Scholar
Publications: "U.S. Health Care Finance: Need for a New Structure." *SRA Quarterly Commentary,* Second Quarter, 2001.

James K. Galbraith Senior Scholar
Presentations: Editor (with Maureen Berner). *Inequality and Industrial Change: A Global View.* Cambridge, Mass.: Cambridge University Press, 2001.
Presentations: "Inequality in China and the World Economy" and "Current U.S. Economic and Political Conditions," Distinguished Fulbright Lectures, Tsinhua University and University of International Trade and Finance in Beijing, Northwest University and Foreign Languages University in Xi'an, Nanjing University and Nanjing Normal University in Nanjing, and Shanghai Jiaotong University and Tongxi University in Shanghai, June 21 to July 2; "Future History: The Humphrey-Hawkins Process and the Deeper Thought of Alan Greenspan," History of Economic Thought Society of Australia, Hobart, July 12; "Global Coup: The Evolution of Inequality in the World Economy under Neoliberalism," Hawke Institute, University of South Australia, Adelaide, July 19, and the Whitlam Institute, University of Western Sydney, July 24.

Malcolm Sawyer Visiting Senior Scholar
Publications: "The Economic Analysis Underlying the 'Third Way'" (with Philip Arestis). *New Political Economy* 6:3 (2001).
Presentations: "The Causes of the Decline of the Euro," Università di Napoli Federico II, Italy, May 23 and 28; "The Welfare State" workshop, University of the Basque Country, Bilbao, June 23; "A Contribution to the Analysis of Endogenous Money," Association for Heterodox Economics, London, July 8, and the *Problemas del Desarrollo* 32nd anniversary theoretical seminar, Mexico City, September 4.

Edward N. Wolff Senior Scholar
Publication: Editor (with Thomas M. Shapiro) and author of included article "Recent Trends in Wealth Ownership, from 1983 to 1998." *Assets for the Poor: The Benefits of Spreading Asset Ownership.* New York: Russell Sage, 2001; *Review of Growth and Distribution* by Duncan K. Foley and Thomas R. Michl. *Journal of Economic Literature* 39:1 (2001).
Presentations: "Skills, Computerization, and Earnings in the Postwar U.S. Economy," Federal Reserve Bank of New York, April 26; "Is Wealth Becoming More Polarized in the United States?," European Society of Population Economists, Athens, June 14-16.

L. Randall Wray Visiting Senior Scholar
Presentations: "Understanding Modern Money," Association for Heterodox Economics, London, July 8.

Jörg Bibow Visiting Scholar
Publication: "Making EMU Work: Some Lessons from the 1990s." *International Review of Applied Economics* 15:3 (2001); "The Loanable Funds Fallacy: Exercises in the Analysis of Disequilibrium." *Cambridge Journal of Economics* 25 (2001); "The Markets versus the ECB, and the Euro's Plunge." *Eastern Economic Journal* 27 (2001).

Willem Thorbecke Research Associate
Presentations: "The Rise and Fall of the Inflation Risk Premium," Western Economic Association Meetings, San Francisco, July 8; "Incorporating Credit Factors into a CGE Model of the Indonesian Economy," Asian Development Bank-Institute, Tokyo, July 25; "U.S. Structural Change: Macroeconomic Policy Issues," Rutgers University Law School, Newark, September 14.

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