The Jerome Levy Economics Institute of Bard College

# Summary

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# Letter from the Executive Director

To our readers:

This issue of the *Summary* includes activities in three research programs and miscellaneous research topics. In the federal budget policy program are five new working papers. Research Associates Michael Hudson and

Kris Feder show that because two-thirds of capital gains are taken in (unproductive) real estate, a cut in the capital gains tax rate produces changes in the efficiency-equity trade-off that cannot be ignored. They suggest that any reduction in capital gains taxes be targeted to specific productive activities. In a series of three working papers, Visiting Scholar David A. Aschauer uses state-level data to estimate the static and dynamic effects on output and employment growth of public capital investment. Senior Fellow Walter M. Cadette examines proposals for the long-term funding of Social Security and concludes that reforming the current system is a better alternative than privatizing it.

Activities in the employment policy and labor market structure program include five new working papers and a conference. Senior Scholar Joel Perlmann and Research Associate Roger Waldinger examine 1990 PUMS data to determine if conditions for the second generation of immigrants, especially those of Mexican descent, are as poor as preliminary research has indicated. In a second paper by Perlmann, he examines the racial classification used by the Census Bureau and other methods that have been proposed and argues for a method that allows census respondents to declare multiple racial ancestries. Research Associates Judith Fields and Edward N. Wolff study industry wage premia to explore gender wage differentials; they find that the differentials can be explained only in part by the distribution of women and men in different industries and that other factors, such as discrimination, play a role as well. In a paper by Rebecca M. Blank, of Northwestern University, she notes that the widening wage dispersion in the United States and high rates of unemployment in Europe may both be explained as resulting from differing responses to the same economic transformations, including changing patterns of international trade and rapidly changing technology. Visiting Scholar Marlene Kim finds that too little work and too low wages are among the reasons that millions of Americans who work are still poor; although many of the working poor are employed less than full-time, most would remain in poverty if they could work full-time. Among the activities this spring was the annual employment conference, this year focusing on policy proposals to promote employment by increasing long-run economic growth; included in this issue is a synopsis of talks by featured speakers.

Research in the program on restructuring in the financial services sector is represented in this issue by a working paper by Research Associate Willem Thorbecke and the sixth annual conference on financial structure. Thorbecke examines the relative costs and benefits of disinflationary monetary policies for firms (by size and sector) and workers (by income group and race). Addresses by the featured conference speakers are summarized.

One working paper is summarized under miscellaneous research topics. Resident Scholar Oren M. Levin-Waldman analyzes data from the 1952 to 1992 National Election Studies cumulative files and finds that the decline in union membership in the United States caused a drop in voter participation primarily among Democrats; he concludes that the results of the 1994 election had less to do with voter ideology than with voter participation. This issue also includes a synopsis of a recent book by Levin-Waldman on his reinterpretation of liberalism as a political philosophy and a guide for contemporary policy.

As always, I invite your comments on the *Summary.*

Dimitri B. Papadimitriou
Executive Director

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# New Working Papers

### Real Estate and the Capital Gains Debate

**Michael Hudson and Kris Feder**
**Working Paper No. 187, March 1997**

The recent budget agreement contains a capital gains tax cut. The principal justification for reducing the capital gains tax rate relies on the efficiency-equity trade-off. The capital gains tax is designed to increase equity by taxing the wealthy, but, advocates of rate reduction claim, the tax has the side effect of decreasing efficiency because it discourages productive investment. The argument is that the tax structure errs on the side of equity so much that it has reduced the efficiency of the economy to the point where there is less wealth for everyone, and so a capital gains tax cut is needed to get the economy moving.

Research Associates Michael Hudson, of New York University, and Kris Feder, of Bard College, call attention to a neglected aspect of the capital gains debate: Two-thirds of capital gains are taken on real estate, that is, on unproductive investment. The efficiency-equity trade-off is a valid point that cannot be ignored when discussing taxes on productive investment. But, because land cannot be produced, an investment in real estate merely changes ownership of existing wealth; it does not produce wealth. Any capital gains on the appreciation of land value are not a reward for productivity but a windfall for whoever happens to own the land. Yet, the capital gains tax treats a return from the appreciation of land the same way it treats a return resulting from improvements to land or from business investment.

Such a tax structure is both inefficient (because it rewards unproductive investment at the expense of productive investment) and inequitable (because it rewards some of the wealthiest individuals at the expense of everyone else). There is an efficiency-equity trade-off on productive investments such as capital, but not on fixed assets such as land. Therefore, Hudson and Feder argue that we should not decrease the capital gains tax unless we first separate returns to business investment from returns to real estate speculation and tax real estate at a higher rate.

Hudson and Feder point out the distortionary loopholes that the tax system provides for real estate holders and speculators. By allowing real estate property to be depreciated every time it is resold, the tax system allows what would otherwise be treated as regular income to be counted as capital gains. This twice reduces the effective tax rate because capital gains tax rates are lower than income tax rates and capital gains taxes are deferred until the land is sold. Because most real estate cash flow is exempt from the income tax, the capital gains tax is the only major tax that landholders pay. This tax arrangement gives them an incentive to borrow excessively on their real estate holdings, thereby converting rental income into nontaxable interest cost while capital gains accrue. Mortgage interest income, which currently absorbs 7 percent of national income (up from 1 percent in the late 1940s), also avoids taxation. Moreover, the capital gains tax rate is further reduced by numerous other exemptions.

Some research estimates that a nominal capital gains tax rate of 28 percent translates to an effective rate of only 7 percent. [1] The lower tax burden represents a subsidy to financial, insurance, and real estate (FIRE) industries at the expense of manufacturing and services. Hudson and Feder note that this could explain why the FIRE sector has been the most rapidly growing part of the economy over the past half century.

One problem with the current tax system (that could be solved by restructuring) is that it does not yield accurate statistics on how national income is divided among returns to land, labor, and capital. The IRS benchmark survey of 1985 showed that a total of $208 billion was declared as capital gains that year, 19 percent of which were real estate gains. The total, however, does not include institutional and foreign real estate holders (both of whom are exempt from capital gains taxes) nor does it include capital gains that accrued but were not realized during the year. Federal Reserve Board figures were much higher: an estimated gain in building values of $204 billion and a gain in land values of $356 billion. However, even these statistics underestimate the increase in land values because they value buildings at replacement cost, ignoring the fact that with depreciation buildings tend to be worth far less than replacement cost. The true value of a building is the difference between the price of the lot on which the building is located and the price of a vacant lot in the same location. If official statistics were calculated in this way, they would show that a much larger portion of real estate gains derives from the appreciation of land than from improvements to land. There are no sound statistics on total returns taken by landlords or the portion of those returns paid in taxes.

According to Hudson and Feder, the recent across-the-board decrease in the capital gains tax rate will not significantly increase productive behavior, but will instead benefit landlords as a group regardless of their behavior. They advocate targeting the tax so that it rewards productivity by separating land from other types of

assessed capital gains. The authors conclude that the current tax system is inefficient because it allows unproductive investment to avoid nearly all taxation, forcing the productive sectors to bear a larger tax burden and thus reducing the incentive for productive investment. The current tax system is inequitable because it taxes people who do not own land or own only their own home more than it taxes landlords (who tend to be wealthier). Therefore, separating land gains from capital gains and taxing land at a higher rate can increase both efficiency and equality.

Hudson and Feder make four suggestions for the direction of tax policy. (1) Do not reduce capital gains taxes on buildings. (2) Do not reduce capital gains taxes on land. Rewarding ownership of fixed assets encourages speculation, not production. (3) Do not permit buildings to be depreciated more than once. Redepreciation converts what is really a current income liability into a deferred capital gain. (4) Distinguish returns to land from other types of assessed capital gains and tax those returns separately. Improve the quality of statistics and accounting in the NIPA to allow for this type of targeting. In short, instead of taxing capital and labor to subsidize landholding, policy should increase the equity and efficiency of the tax system and promote growth by maintaining taxes on unproductive activity and reducing taxes on productive activities.

**Note**

1. See Steven M. Fazzari and Benjamin Herzon, "Capital Gains Tax Cuts, Investment, and Growth," Levy Institute Working Paper No. 147, October 1995.

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## Do States Optimize? Public Capital and Economic Growth

**David Alan Aschauer**
**Working Paper No. 189, April 1997**

## Output and Employment Effects of Public Capital

**David Alan Aschauer**
**Working Paper No. 190, April 1997**

## Dynamic Output and Employment Effects of Public Capital

**David Alan Aschauer**
**Working Paper No. 191, April 1997**

Studies that have examined the effect of public spending on economic growth have reported estimates for the marginal product of public capital that are well in excess of, equal to, and less than the marginal product of private capital. Not only does this wide range of estimates call for further examination, but several questions about such spending have been neglected:

- Does a permanent increase in public spending induce a permanent or temporary increase in economic growth?
- Is public capital sufficiently productive to increase the rate of economic growth?
- Does the method by which new (public) spending is financed have a larger negative effect on growth than any positive effect induced by the increase in spending itself?

Visiting Scholar David Alan Aschauer, of Bates College, explores these issues, making use of state-level data to examine the static and dynamic effects of public capital spending on output and employment growth.

**Growth Model (Working Paper No. 189)**

Aschauer formulates a growth model that contains a utility function and a Cobb-Douglas production function. The utility function has constant intertemporal elasticities of substitution and is maximized by producers and consumers; in the production function capital is divided into two components: public infrastructure capital and a broad measure of private capital containing both tangible and human capital. The production function exhibits constant returns to scale across private and public capital inputs, but increasing returns to scale across raw labor and capital. The government sector purchases and maintains a stock of public capital that is proportional to the stock of private capital. Public capital also is assumed to have some positive productivity effect on private capital. The initial public capital stock is funded by the issuance of perpetuities (debt) and is thereafter maintained by a tax levied on private production.

According to Aschauer's theoretical model, there is a nonlinear relationship between public capital and economic growth. When the ratio of public to private capital is low, the productivity effect resulting from a rise in that ratio will dominate the tax effect (the higher tax rate necessary to finance the rise in the public capital stock). This causes the after-tax marginal product of capital to rise, private capital to accumulate, and (permanent) economic growth to increase. However, at a sufficiently high ratio of public to private capital, the tax effect overwhelms the productivity effect and the growth rate declines. Economic growth is therefore maximized at the ratio of public to private capital that sets the marginal product of public capital equal to the after-tax marginal product of private capital.

Using state-level data, Aschauer empirically estimates the effects on the output growth rate of changes in the ratio of public to private capital and other variables using both linear and nonlinear specifications. He concludes that the linear estimates cannot be assumed to be robust across estimation methods and therefore runs three nonlinear regressions with specifications similar to the linear regressions. The estimates of the first two nonlinear regressions, which included the public capital ratio and initial output per worker as explanatory variables, were similar to the estimates of their comparable linear specifications, that is, they showed positive and statistically significant relationships between the public capital ratio and economic growth and convergence of this effect across states. The results indicated no preference for one estimation method (linear versus nonlinear) over the other. However, the notable increase in the size of the coefficients, the rise in explanatory power, and the decline in the standard errors in the third nonlinear regression, which included separate fixed effects for the 48 contiguous states included in the sample, indicated that there is a statistically significant role for public capital in output growth, that the relationship between the two is nonlinear, and that there is little support for a convergence effect across states. Assuming an output elasticity of public capital of 0.30 and using actual values for the public capital ratio, Aschauer finds that for 87 of the sample's 96 observations, the public capital ratio fell below the growth-maximizing value of 0.612.[1] The finding suggests "that for many states an insufficient level of investment in public capital may have been responsible for relatively sluggish productivity growth in recent decades."

Aschauer then uses the same (nonlinear) specification for the public capital ratio and a new (flow) specification for the ratio of government spending to private capital in a new regression to explore whether a higher level of government spending reduces economic growth.[2] His coefficient estimates indicate that a permanent increase in either government spending or public capital could have a permanent, positive effect on output growth. Applying actual values to the estimates, Aschauer finds that the level of public capital stock lies below and the level of government spending lies above their respective growth-maximizing levels, indicating deficient spending on public capital and excessive government spending. However, because some research indicates that the type of public capital may determine the size of its effect on economic growth, he runs a new regression in which core public capital (spending on streets and highways and water and sewer systems) is separated from other public capital (primarily spending on schools and hospitals), while retaining the government spending variable. Again, all three variables have positive coefficients. Applying actual values to the estimates, Aschauer finds that both public capital variables have positive effects on economic growth, although, "perhaps

surprisingly," the level of other public capital has a larger effect on economic growth than core public capital. And again, the level of government spending is found to have a negative effect on growth.

**Static Analysis (Working Paper No. 190)**

To examine the static effects of public capital, Aschauer applies ordinary least squares, weighted least squares, and seemingly unrelated regression techniques to the state-level data. He finds that during the 20-year period between 1970 and 1990 the average public capital ratio was 0.446, 26.0 percent below the output growth-maximizing ratio of 0.603. Most (87.5 percent) of the 96 observations fell below the output growth-maximizing value, with the gap between that value and actual values reaching as high as 68.0 percent. Moreover, marginal output effects ranged between 0.528 and -0.245 and employment growth effects ranged between 0.265 and -0.106. (Average values of output growth and employment growth were, however, both positive.) Adding the effects of government financing (debt and taxes) to the estimates yielded higher values for the output growth maximizing and employment-maximizing levels of public capital, with output and employment growth rates each negatively related to both public debt and tax revenues. Over the 20-year period the net growth effect was positive for 77.1 percent of the sample and the net employment effect was positive for 74.0 percent. From an examination of changes in the effects of public capital over time, Aschauer finds that, because the public capital stock grew at a slower pace than the private capital stock, the gross and net output and employment effects of public capital grew appreciably during the 1970s and 1980s (a finding that Aschauer notes rationalizes on statistical grounds claims made in some policy discussions of an "infrastructure crisis" in the United States).

Aschauer then divides the sample in two ways: first into Sunbelt and Snowbelt states and second into core and other public capital components. When he divides them the first way, he finds that the net output and employment effects of public capital were the same in both regions despite the fact that Sunbelt states had lower public capital ratios than Snowbelt states. The similarity in net effects is explained by a higher sensitivity of growth and employment to public capital in the Snowbelt (for example, the growth-and employment-maximizing values for the public capital ratio were higher in the Snowbelt than in the Sunbelt). So, although lower public capital ratios in the Sunbelt would support an argument in favor of higher relative levels of public capital investment in that region, the higher sensitivity of such spending in the Snowbelt justifies increased investment in both regions.

When Aschauer divides public capital into core and other public capital components, he finds that the net marginal output and employment effects of other public capital, but not core public capital, are positive. He reconciles this seemingly counterintuitive finding by noting that differences in the methods by which the two types of public capital are financed could affect the results. If, for example, core public capital is disproportionately financed through federal grants, then, from the perspective of an individual state, the differential effect of core capital would be higher than estimated.

**Dynamic Analysis (Working Paper No. 191)**

Aschauer explores the long-run effects of an increase in productivity stimulated by, for example, an increase in the public capital stock. Because of the assumed stability of the two-equation model, the growth rates of output and employment converge to zero over time. Empirical estimates bear out this assumption. His results show that

- A 1.0 percentage point increase in the public capital ratio (from the sample average) results in a 0.203 percent per year increase in output and a 0.077 percent per year rise in employment.
- Both output and employment growth depend positively on the initial level of output and negatively on the initial level of employment.
- The paths for output and employment growth are stable, yet oscillatory.

A permanent increase in the public capital stock from 0.45 (close to the sample average of 0.446) to 0.50 results in an initial increase in output growth of 0.8 percent per year (peaking at a rate of 0.9 percent per year after 9 years) and an initial increase in employment growth of 0.3 percent per year (peaking at 0.5 percent per year after 15 years); as a consequence, productivity growth expands by 0.5 percent per year. According to

Aschauer's estimates, it will take at least 100 years before the full effects of the change in public capital on economic growth disappear. Over a 200-year time period output climbs by 27.2 percent and employment by 20.8 percent.

Aschauer notes three reasons for the large size of the long-term effects. First, the size of the cumulative effects is not so much due to the modest initial effect, but largely due to the persistence of the increase in growth rates. Second, because the increase in the public capital stock is a permanent one, its expansion will require an increasing level of public investment to match the induced rise in the private capital stock.[3] Third, much of the increase in output can be attributed to an increase in employment, which, in turn, can be traced to an increase in the labor force. According to Aschauer, such an increase in the labor force can be considered reasonable if the (permanent) rise in the public capital stock is limited to a particular state, which can then draw from the labor force in all other states. If, however, the increase in the public capital stock is spread more broadly, say, over a region or the entire country, then a more modest increase in the labor force would be reasonable.

The current model assumes an endogenous labor force; that is, any increase in employment must come from an increase in the labor force. Aschauer changes this assumption to an exogenous labor force; that is, the labor force is assumed fixed, so that a rise in employment comes from a decrease in unemployment. He finds that the cumulative effects of a permanent change in the public capital stock on output and employment growth are much smaller under assumptions of an exogenous labor force, although the productivity effects are a bit larger.

Adding financing to the dynamic model, Aschauer finds that debt and taxes each have a negative effect on both output and employment growth. Again, output and employment growth are positively related to the initial level of output and negatively related to the initial level of employment. However, the estimated coefficients suggest that the endogenous labor force model is unstable.

Aschauer concludes that the results of the dynamic model suggest that more attention should be paid to the distinction between the endogenous and exogenous labor force specifications of the model. Of particular interest would be the interregional and interstate migration of labor. Moreover, the results of both the static and the dynamic models suggest that future research might examine how different methods of financing public capital investment affect output at the state level.

**Notes**

1. The assumed value of the output elasticity of public capital was taken from the best-fitting nonlinear specification of the empirical model. Best fit is determined by the maximum value of the log liklihood function of the estimating equation.

2. In this estimate, government spending is defined as government consumption spending exclusive of defense spending and noncapital expenditures on education.

3. Aschauer notes that, from a policy standpoint, a more realistic assumption might be a temporary rise in the public capital ratio. He finds that a temporary increase of 5.0 percentage points that gradually diminishes at a rate of 0.1 percentage point per year over a 50-year period results in a rise in the output growth rate of 0.8 percent per year; employment, 0.4 percent per year; and productivity, 0.5 percent per year. However, these effects begin to decline earlier (output growth after 2 years and employment growth after 12 years).

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## Social Security: The Challenge of Financing the Baby Boom's Retirement

**Walter M. Cadette**
**Working Paper No. 192, April 1997**

Some reform of Social Security is needed to keep the system solvent given the additional financial pressure that will be placed on it as the baby boom generation retires. The Social Security Administration estimates that

payroll taxes will have to be increased 2.2 percent or benefits reduced 2.2 percent to maintain financial balance over the next 75 years. The Advisory Council on Social Security has suggested two possible approaches to the long-term financing of the system. One would make minor changes to the existing system to close the gap between contributions and benefits; the other would privatize and thus radically alter the system. Senior Fellow Walter M. Cadette examines these two approaches and concludes that the nation would be better off reforming the current system than making such a fundamental change as privatization.

Social Security is essentially a pay-as-you-go system. The "contributions" of today's workers are not saved for their own retirement; instead, they are paid out as the benefits of today's retirees. Social Security so far has succeeded in making every generation of retirees net "winners," that is, retirees receive more in benefits than they and their employers paid into the fund. This has been possible because economic growth has made each generation of workers more productive than the last. Every generation can continue to be net winners as long as the productivity of the working population grows faster than the benefits of retirees.

However, this pattern is threatened by rising benefits and a declining ratio of workers to retirees. Increasing life expectancies and the population spike of the baby boom have combined to reduce the worker-to-retiree ratio from 4 to 1 thirty years ago to 3.2 to 1 today, and, if current trends continue, it will fall to 2 to 1 thirty years from now. It is not possible to continue to make all recipients net winners over the next 75 years without a 2.2 percent increase in taxes or decrease in benefits.

The privatization plan diverts 5 percentage points of the current 12.4 percent payroll tax to individual security accounts, which would operate much like private 401(k) plans. The major purported advantage to privatization is that it will increase the private saving rate. Cadette argues, however, there is no assurance that it will do so and there are other ways to encourage saving that would not force the poor to put their retirement at risk. Moreover, the change from a pay-as-you-go to an advance funding system would be expensive for the transition generation that would be stuck with both supporting the benefits of current retirees and paying into a fund for their own retirement.

The major shortcoming of privatization, according to Cadette, is that it will remove the guaranteed base level of income support that has been the main achievement of Social Security. To allow private control of an individual's only retirement fund is to create a risk that many are not in a financial position to take. Some will make substantial gains, but others are bound to lose money. People who are unwise or unlucky with their privatized investments will be forced to spend their retirement in poverty. Privatizing Social Security will increase poverty and decrease security.

The Advisory Council's alternative proposal is to leave the existing system intact with some modest reforms to close the gap between contributions and benefits. A combination of benefit reductions and tax increases could reduce the gap by two-thirds. The remaining third could be eliminated by investing 40 percent of system reserves in equities, which historically have yielded higher returns than the Treasuries in which the reserves are currently invested. Investing the trust fund in the market would not be a fundamental change to the system and would provide more security to retirees than privatization. However, Cadette notes that it would subject the trust fund to greater risk than it now has and also would have an uncertain effect on the overall saving rate. Cadette proposes the even more cautious approach of instituting only changes in the tax and benefit scheme to close the gap. He suggests four modest reforms. First, increase the mandatory retirement age and index it to life expectancy so that the ratio of years spent working to years spent in retirement remains constant as life expectancy rises. Second, gradually increase the payroll tax so that it slows but does not reverse, even temporarily, the growth of after-tax wages. Third, increase the maximum payroll tax paid by high-income earners. Fourth, adjust the way benefits are calculated for early retirement. A combination of these reforms would make Social Security actuarially sound while leaving its basic structure and guarantees in place until the year 2072.

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# Program 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?*

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.

Kris Feder is an assistant professor of economics at Bard College. Her areas of specialization are public sector eco-nomics and history of economic thought. She received a Ph.D. in economics from Temple University. Michael 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, with G. J. Miller, of *A Philosophy for a Fair Society,* published by Shepheard-Walwyn.

> 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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# New Working Papers

### The Second Generation and the Children of the Native Born: Comparisons and Refinements

**Joel Perlmann and Roger Waldinger**
**Working Paper No. 174, November 1996**

Recent discussion and some preliminary research have given a negative prognosis for children of immigrants.[1] Senior Scholar Joel Perlmann and Roger Waldinger, professor of sociology at the University of California at Los Angeles, examine 1990 Census Public Use Samples (PUMS) to determine if conditions for the children of immigrants are as poor as indicated. They are particularly interested in second-generation Mexicans as

Mexicans constitute the largest group among immigrants and the group most uniformly composed of workers who are unskilled or semiskilled and have relatively little education or capital. Given that Mexican immigrants make up such a large proportion of all immigrants, the authors want to find out if the Mexican experience differs from that of all other immigrants, because if it does, it may affect the data in ways that misrepresent the experience of all non-Mexican immigrants.

Perlmann and Waldinger examine data from three subgroups of the 5 percent and 1 percent data sets of the PUMS--children (aged 17 and younger) living with their parents (which provides a profile of immigrant households of origin), young adults (aged 18 to 25) living with their parents, and young adults brought to the United States before age 5--to obtain both direct and indirect evidence about the economic well-being of the children of immigrants. They base relative well-being among second-generation immigrants on their parents' occupation. Occupations are grouped into three divisions: high-strata jobs (managerial, professional, and technical), middle-strata jobs (skilled manual, clerical, and sales), and low-strata jobs (service, low-skilled manual, and farming).

Perlmann and Waldinger compare all immigrant parents to all native-born parents and find that immigrant parents are slightly worse off than native-born parents in terms of employment rates and occupational distribution (see Exhibits 1 and 2). The authors then compare parents in different immigrant groups, specifically, Mexican parents to parents from other countries or regions of origin. Although employment rates of Mexican immigrants and non-Mexican immigrants are comparable, their occupational distribution among strata is not. Mexican immigrants hold a higher percentage of low-strata jobs and a lower percentage of high-strata jobs than other immigrant groups, including non-Mexican Hispanic immigrants. The status of Mexican immigrants, however, is not an anomaly among immigrant groups. For example, after adjusting to include those who are unemployed or not in the labor force, the contrast in job distribution between Mexican and non-Mexican immigrants is nearly identical to the contrast be-tween native-born blacks and whites. Similarly, among Asian immigrants, the Indochinese are far more disadvantaged than other Asian immigrant groups.

Perlmann and Waldinger find that these relative levels of well-being are similar when based on the educational status of the children of immigrants. They also find, however, that the occupational profile of all second-generation immigrants is somewhat better than the occupational standing of the native born and, within subgroups, children of non-Mexican immigrants are better situated than native-born whites.

Perlmann and Waldinger do not make judgments about how their findings about the second generation might apply to immigration policy. But they do wish to dispel, at least in part, the notion that all children of immigrants face serious downward mobility or that their opportuni-ties are limited. The negative prognosis appears to be the result of a misinterpretation of the data. To draw more reliable conclusions, it is important to take into account the differences among groups, most notably, to distinguish the Mexican and Indochinese experiences from those of other immigrants.

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**Exhibit 1 Employment Status of Immigrant and Native-Born Head of Household (with Children Ages 0-17)**

| | Percentage | | | | | Ethnic Origin | Employed | Unemployed | Not in the Labor Force | Total | Number of Observations |
|---|---|---|---|---|---|---|---|---|---|---|---|
| All immigrants | 82 | 5 | 13 | 100 | 40,037 | | | | | | |
| **Non-Mexican immigrants** | **83** | **4** | **13** | **100** | **27,875** | | | | | | |
| Mexico | 81 | 8 | 12 | 100 | 12,162 | | | | | | |
| Puerto Rico | 61 | 7 | 33 | 100 | 2,554 | | | | | | |
| Caribbean | 79 | 6 | 15 | 100 | 3,066 | | | | | | |
| Other Hispanic | 86 | 5 | 9 | 100 | 3,873 | | | | | | |
| Indochina | 56 | 4 | 39 | 100 | 1,919 | | | | | | |
| Other Asian | 90 | 3 | 7 | 100 | 7,540 | | | | | | |
| Europe and Canada | 90 | 3 | 7 | 100 | 7,656 | | | | | | |
| All other | 85 | 4 | 11 | 100 | 1,267 | | | | | | |
| **All native-born** | **85** | **4** | **10** | **100** | **24,759** | | | | | | |
| Native-born black | 66 | 10 | 23 | 100 | 2,981 | | | | | | |
| Native-born white | 89 | 3 | 8 | 100 | 20,820 | | | | | | |
| Native-born other | 70 | 9 | 21 | 100 | 958 | | | | | | |

*Note:* "Ethnic origin" refers to place of birth for immigrant heads of household and to race for native-born heads.
*Source:* 5 percent PUMS data. See also notes to Table 2 of the working paper.

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**Exhibit 2 Occupation of Gainfully Employed Immigrant and Native-Born Head of Household (with Children Ages 0-17)**

| Ethnic Origin | Percentage | | | | Number of Observations |
|---|---|---|---|---|---|
| | High Strata | Middle Strata | Low Strata | Total | |
| All immigrants | 28 | 33 | 38 | 100 | 32,928 |
| **Non-Mexican immigrants** | **37** | **34** | **29** | **100** | **23,117** |
| Mexico | 8 | 32 | 61 | 100 | 9,811 |
| Puerto Rico | 24 | 34 | 43 | 100 | 1,546 |
| Caribbean | 25 | 36 | 40 | 100 | 2,420 |
| Other Hispanic | 24 | 34 | 41 | 100 | 3,324 |
| Indochina | 23 | 33 | 44 | 100 | 1,083 |
| Other Asian | 46 | 33 | 20 | 100 | 6,788 |
| Europe and Canada | 41 | 35 | 24 | 100 | 6,880 |
| All other | 47 | 29 | 24 | 100 | 1,076 |
| **All native born** | **31** | **38** | **32** | **100** | **21,155** |
| Native-born black | 19 | 33 | 48 | 100 | 1,980 |
| Native-born white | 32 | 38 | 30 | 100 | 18,502 |
| Native-born other | 24 | 39 | 37 | 100 | 673 |

*Note:* "Ethnic origin" refers to place of birth for immigrant heads of household and to race for native-born heads. The gainfully employed are those listed in Exhibit 1 as "employed." The number of observations is the total number of gainfully employed in the relevant subsamples. Sampling ratios differ by nativity: 1/2000 (1 percent x 1/20) of the actual population for natives, 1/200 (5 percent x 1/10) for immigrants.

*Source:* A 1/10 subsample drawn from the 1990 PUMS 5 percent sample for children of immigrants and a 1/20 subsample drawn from the 1990 PUMS 1 percent sample for children of natives. See also notes to Table 2 of the working paper.

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### Note

1. For a theoretical discussion of "second-generation decline" (or, "segmented assimilation"), see Joel Perlmann and Roger Waldinger, "Assimilation: The Second Generation, Then and Now," Levy Institute Working Paper No. 168, June 1996.

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

**Judith Fields and Edward N. Wolff**
**Working Paper No. 186, March 1997**

The facts that some industries pay higher wages than others pay for the same grade of labor and that women tend to be paid less than men have been amply demonstrated in the economics literature. Research Associates Judith Fields, of Lehman College, City University of New York, and Edward N. Wolff, of New York University, studied the interaction of these two conditions to estimate how much of the gender gap can be explained by the distribution of women and men in different industries and how much of it must be explained by other factors such as discrimination. They make the case that focused antidiscrimination policy can be effective in reducing the gender gap.

Fields and Wolff studied the gender difference in wage premia, defined as average industry wage levels adjusted for age, education, and industry characteristics. Both efficiency wage and equity wage theories have

been used to explain the existence of wage premia. The pattern of wage premia is similar for men and women, but not identical. Fields and Wolff found that the gender gap in wage premia explained 12 to 22 percent of the overall gender gap, and differences in the distribution of male and female employment across industries with different wages and wage premia explained another 13 to 19 percent.

Fields and Wolff examined the causes of the gender gap using a two-step econometric analysis and data on individual wages and related characteristics contained in the 1988 Current Population Survey. Their principal interest was the gender gap in industry wage premia (GGIWP), which is the difference between male and female pay in an industry after netting out all of the wage differences associated with productivity-related characteristics. They first regressed wages as a function of education, experience, marital status, race, and dummy variables for location and occupation. Using their results, they calculated the GGIWP and then regressed it (using both ordinary least squares and weighted least squares to account for possible heteroskedasticity) on nine industry characteristics using two data sets, one using all of the 156 industries for which data are available and one using the 81 industries for which male and female industry dummy variables for full-time, full-year workers were both statistically significant at the 10 percent level.

The authors used the relative incidence of federal contractor firms in the industry as a proxy variable for the likelihood that a firm in that industry might be the target of an affirmative action compliance review. They found the coefficient of affirmative action to be negative and statistically significant at the 5 percent level in three out of the four regressions and at the 10 percent level in the other, implying that the likelihood of an affirmative action investigation reduces the gender gap. This finding contradicts Leonard's results,[1] which indicate no significant effects of affirmative action. Fields and Wolff note that a possible explanation for the discrepancy is the fact that Leonard was focusing on the gender gap in wages rather than on the gender gap in wage premia.

Fields and Wolf also found that employment growth had a negative coefficient and was significant at the 1 percent level in three of the regressions and at the 5 percent level in the other, implying that industry growth is associated with a decline in the gender gap. Growth lowers barriers and increases opportunities for women, while stagnation may create a situation in which already-employed men feel the need to protect their positions.

The coefficient of the average profit rate was negative and significant at the 1 percent level in all four regressions, a finding consistent with both efficiency and equity wage theories. Profitable industries may have more funds available for wages of both male and female employees.

The coefficient of average plant size was positive and significant at the 10 percent level or higher in three of the four regressions, which may reflect the fact that larger plants tend to be unionized and pay higher wages to (usually male) senior workers.

The percentage change in annual payroll and percentage change in total sales both had positive coefficients that were significant in most of the regressions. The fact that employment growth tends to narrow the gender gap while these variables tend to widen it suggests that industries that respond to increases in demand by increasing employment narrow the gender gap, but those that respond without increasing employment tend to leave the existing male-dominated workforce in place.

Average years of schooling for workers and average assets per employee were not found to be statistically significant, implying that education and the capital-labor ratio do not affect the gender gap.

Although Fields and Wolff's findings of the effectiveness of affirmative action are more hopeful than Leonard's, their policy recommendations are similar. Affirmative action compliance reviews will be most effective if targeted at fast-growing, high-profit industries in which there are more opportunities to increase female wages and employment with the least adverse effects on existing male employees.

## Note

1. Jonathan S. Leonard,"Affirmative Action Thirty Years Later: Wage Disparities and Affirmative Action in the 1980's," *American Economic Review* 86, 2 (1996): 285-301.

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

**Rebecca M. Blank**
**Working Paper No. 188, April 1997**

High unemployment rates and increasing terms of unemployment have persisted in western European countries for the past 20 years. These problems have been explained as resulting from inflexibility in the labor market created by such policies as protective labor market regulation and generous social assistance. The lower rates and shorter duration of unemployment in the United States were thought to result from greater labor market flexibility. On the basis of this analysis, European nations enacted changes, such as weakening regulations, to increase labor market flexibility. However, labor market analysts have found not only that such efforts have been largely unsuccessful at reducing unemployment or increasing labor mobility,[1] but also that the United States experienced rising wage inequality over the same time period that unemployment problems occurred in Europe. In other words, both the United States and Europe face serious labor market problems. In this working paper, Rebecca M. Blank, of Northwestern University and the Northwestern University/University of Chicago Joint Center for Policy Research, analyzes these problems to assess the extent to which they reflect different institutional responses to related economic problems.

Some researchers attempt to identify links between rising wage inequality in the United States and unemployment in Europe. According to their hypothesis, which Blank refers to as the "unified theory," there has been a transformation in fundamental economic forces, such as technology and the pattern of international trade. These transformed forces have the same effects on labor demand in the U.S. and the European labor markets, but the ensuing changes in wages and employment are determined by the relative degree of flexibility in each market. The comparatively open labor markets in the United States produce shifts in relative wages, while the more rigid wage structure in Europe leads to changes in hiring and firing and thus to greater unemployment.

Blank points out that although the unified theory receives some support from the timing of events (labor market problems in the United States and Europe occurred at the same time), other empirical evidence is mixed. The theory suggests a trade-off between unemployment and wage inequality, but that type of correlation across countries is mild, with some countries experiencing both problems. If the unified theory is correct, we would expect that similar types of workers would be experiencing relative wage declines in the United States and relative unemployment rate increases in Europe, but here, too, the results are mixed. In the United States less-skilled workers have seen declines in relative wages. In some European countries less-skilled workers have experienced large increases in unemployment relative to more-skilled workers, although age appears to be a more defining characteristic (with unemployment relatively higher among younger than older workers).[2] Blank concludes that while there is much that analysts do not understand about the extent to which U.S. and European labor markets are linked, similar demand shifts do appear to have affected many of the industrialized nations, and the result of these shifts within individual labor markets appears to have depended on the structure of their institutions. However, other factors, such as demographic shifts and each country's "own unique set of economic and social forces" (such as the shape of public policy) appear to have played a role in labor market changes as well.

Blank suggests that there are several directions that public policy might take in the presence of labor market problems. One response is to do nothing in the hope existing imbalances will disappear. This approach has failed. A second response is to insulate the national economy from the economic changes that have provoked existing problems. Few countries have chosen this path, which Blank notes is fortunate as prevailing economic thought suggests that creating barriers to trade and economic change generally has larger negative long-run consequences than positive short-term effects. Blank suggests a third, and "good," response. Governments should recognize that there are no quick and easy solutions to institutionally ingrained problems; they therefore

must confront problems directly by enacting a long-term plan that will offset and reduce adverse labor market effects.

According to Blank, "good policy choices will require mixing some of the best aspects of labor market flexibility with well-run activist labor market and social protection policies." Ongoing labor market changes can be offset through (1) active labor market policies designed to subsidize or raise wages or increase employment, such as job placement and training programs, subsidies and tax incentives for hiring disadvantaged workers, and public sector employment; and (2) a reasonable social safety net that offers assistance through either existing unemployment and assistance programs, such as the earned income tax credit, or new programs, such as part-time unemployment subsidies for involuntary part-time workers.

**Notes**

1. Although it might be the case that the changes enacted by European nations were not dramatic enough to make a discernable difference, the small size of these effects alone suggests that "the problems facing Europe's labor markets go beyond the institutional structures and rules that exist within these countries."

2. This does not necessarily contradict the unified theory; protective regulations in European labor markets that make it harder to fire older workers may have pushed an undue burden of unemployment on younger workers of all skill levels.

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## The Working Poor: Lousy Jobs or Lazy Workers?

**Marlene Kim**
**Working Paper No. 194, May 1997**

Most Americans believe that if they work hard, they should not be poor. Although recent government welfare reform policy is aimed at encouraging people to work more, 7 to 9 million working Americans remain poor. Visiting Scholar Marlene Kim, of the School of Labor and Management Relations, Cook College, Rutgers University, asks, Why are there so many working poor? Are they poor because they choose to work too few hours? If so, why don't they choose to work more? If they worked more, would doing so end their poverty? These questions have significance for public policy. If choosing too few hours is the problem, the only role policy might play is to encourage more work. But, if poverty is caused by forces beyond workers' control, policy could play a more substantial role. Kim finds that many of the working poor do not work more hours because they cannot. She also finds that because their wages are so low, most of the working poor would still be poor even if they worked full-time year-round.

Kim uses data on 57,000 U.S. households in the 1994 March *Current Population Survey* to examine the characteristics of the working poor. She defines working poor as anyone who worked any time during the year and had an income below the poverty line. She uses three alternative benchmarks to define the poverty line: the official government poverty line, 125 percent of the official poverty line, and 150 percent of the official poverty line.

As Exhibit 3 shows, working reduces the poverty rate, but does not eliminate it. Although the poverty rate is much lower among workers than nonworkers, a substantial number of workers live in poverty. Take the case of working single mothers. Only a small percentage of all single mothers with young children (children under 6 years) are working poor (4 percent had an income under the official poverty line in 1993), but this low percentage of working poor is a reflection of the fact that few single mothers of young children work at all. However, of all single mothers of young children who do work, almost half (46 percent) had an income below the official poverty line and more than half (62 percent) had an income below 150 percent of the official poverty line (see Exhibit 4). As also shown in Exhibit 4, the results are similar for the working disabled and the working elderly.

Kim calculates that on average, the working poor are employed only two-thirds of a year, but 68 percent of those under the official poverty line would still be poor if they worked full-time year-round (although they

would improve their standard of living). The remaining 32 percent could move out of poverty if they worked full-time year-round. Of the 32 percent, 60 percent are disabled, laid off, or involuntarily working part-time. If these people are subtracted, Kim finds, only 19 percent of the working poor could escape poverty by working more hours.

To arrive at appropriate policy responses, several questions need to be examined. Who should be expected to work full-time year-round? Why don't those who can escape poverty by working more do so? What should be done for those who cannot? Kim notes that education, training, an expanded earned income tax credit, and an increased minimum wage all might help the working poor. Because the problem is more complex than workers' choosing not to work, clearly, the government needs to do more than simply encourage the poor to work more hours.

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**Exhibit 3 Poverty Rates among Adults, 1993**

| | Percent of Sample Below | | |
|---|---|---|---|
| | 150 Percent of Official Poverty Line | 125 Percent of Official Poverty Line | Official Poverty Line |
| All adults (both working and nonworking) | 27 | 21 | 16 |
| Working adults | 18 | 14 | 10 |
| Nonworking adults | 43 | 35 | 26 |

*Source: Current Population Survey,* March 1994.

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**Exhibit 4 Poverty Rates among the Working Poor, 1993**

| | Percent of Sample Below | | |
|---|---|---|---|
| | 150 Percent of Official Poverty Line | 125 Percent of Official Poverty Line | Official Poverty Line |
| Single parents with children under age 6 | 62 | 56 | 46 |
| Not single parents with children under age 6 | 18 | 14 | 10 |
| Disabled | 31 | 25 | 19 |
| Not disabled | 18 | 14 | 10 |
| Elderly | 16 | 12 | 8 |
| Not elderly | 19 | 14 | 10 |

*Source: Current Population Survey,* March 1994.

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## "Multiracials," Racial Classification, and American Intermarriage--The Public's Interest

**Joel Perlmann**
**Working Paper 195, June 1997**

How the census of 2000 is to count "multiracial" people is a hot topic in Washington. A federal task force

presented a draft of its recommendations in July, and the Office of Management and Budget, after hearing reactions, will make a final ruling in late October. As immigration and intermarriage increase, this issue is becoming more important not only for the Census Bureau, but also for every government agency that counts race and every civil rights case. Senior Scholar Joel Perlmann examines the current methodology, discusses proposed reforms, and concludes that the Census Bureau should allow respondents to declare multiple racial ancestries.

According to Perlmann, racial intermarriage is simply a form of ethnic intermarriage; racial and ethnic data are collected by the same subjective self-classification, but the Census Bureau counts the two very differently. Currently, the census form asks individuals to define themselves racially by selecting one of the following racial categories: black, white, Native American, Asian/Pacific Islander, or other.[1] This forces people of multiracial ancestry to chose one of their ancestries over the others or put themselves into the catch-all "all other" category. One reason for this form of categorization is that civil rights legislation mandates that race categories be "complete and nonoverlapping." The result is a definition of race that ignores the widespread reality of intermarriage. The Census Bureau's projections of the future racial makeup of the United States ignore the existence of multiracials entirely.

In contrast to the race question, the census question about ethnic definition asks people to declare the ancestry with which they most closely identify, but allows them to list more than one. Many Americans have listed two or more ancestries. Keeping track of these ancestries is complicated because of ethnic intermarriage, but this is to be expected, as ethnic intermarriage has become so common that the ethnic lines have become blurred and less important.

Over the past year the Census Bureau has been experimenting with three approaches to racial classification: single race, historical series, and all-inclusive. The single race approach counts as members of a racial group only those who list themselves as one race only. Civil rights activists argue that this approach would have a detrimental effect on racial counts as the basis for civil rights actions because those of mixed race who currently list themselves as members of a minority group would no longer be counted as members of that group if they also listed another racial origin. The historical series approach counts people who are mixes of minority groups and whites as members of minority groups, but combines all those categorized as mixed minorities and those claiming three or more racial categories into a single "multiple race" category. Advocates of defining a "multiracial" group have asked the government to add the multiple race category to census forms, but some civil rights advocates have balked at the idea, fearing that it will undermine civil rights legislation by cutting down the size of each minority group as more members of each group become reclassified as "multiple race."

Perlmann suggests that the all-inclusive approach would satisfy the most important concerns about accuracy, efficiency, and political consequences. This approach counts people with multiracial origins in the same way as people with multiethnic origins, that is, they are counted as part of every racial group from which they claim origin, thereby creating overlapping racial groups that add up to more than 100 percent of the population. Census instructions would be changed from "Mark one only" to "Mark all that apply" or "Mark one or more." There would not be a multiple race category because its existence would set multiracials apart as if they were a separate group and, hence, would tend to increase the significance of race. Allowing people to indicate all groups with which they identify will enable the Census Bureau to make more accurate racial counts that at the same time reflect the blurred lines that intermarriage creates.

Perlmann notes that whatever minimal biological meaning race may have, race has an important social and political meaning. Races refer to those ethnic groups that have been treated differently in the United States. To break down racial barriers, our society has an interest in treating racial intermarriage the same matter-of-fact way we treat ethnic intermarriage. To do this, we must have civil rights legislation that rests on a clear definition of racial membership without being hobbled by ambiguities and inaccuracies. The increasing rate of racial intermarriage, especially among Hispanics, Asians, and Native Americans, makes it essential that we allow people to declare multiracial origins. Current Census Bureau statistics and projections need to be brought in line with the reality of increasing racial intermarriage.

Perlmann responds in two ways to civil rights advocates' fear that permitting multiple responses to the race

question will reduce the size and political strength of minority groups and the range of situations in which civil rights laws can be contested in court. First, the existence of multiracial individuals has long been recognized by the courts. Precedents establishing the eligibility of multiracials for civil rights protection have already been set and will not be affected by a change in Census Bureau categorization. Second, forcing multiracials arbitrarily into one category or the other does not necessarily favor civil rights interests. For example, a multiracial may be put arbitrarily into one category or the other by an employer who could count her as black when she is hired and as white if she is fired.

If the all-inclusive approach is chosen by the Office of Management and Budget this fall, Congress will have to adapt civil rights legislation, which currently relies on nonoverlapping categories. How best to do this depends on how people of mixed racial origins are treated in society. As long as those of mixed race are subject to discrimination, they will need protection. Many civil rights advocates are, not surprisingly, skeptical of any change in the civil rights rules. However, they should carefully consider the long-term advantages of the all-inclusive approach. If people of mixed race become more numerous and are treated like people of mixed ethnic origins, racial divisions will weaken in the United States, just as ethnic divisions have weakened.

**Note**

1. The census has a separate question about Hispanic origin. Perlmann notes that this leads to ambiguity about the racial status of Hispanics.

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# Conference

## Promoting Employment and Economic Growth

On May 1 and 2 the Levy Institute held its annual conference addressing employment issues. This year's conference focused on policy proposals that would increase the rate of employment by increasing long-run economic growth. Featured speakers (whose comments are summarized below) were William E. Curry, management fellow at Yale University and former counselor to President Clinton, and S Jay Levy, chairman of the Levy Institute. Conference sessions were entitled "An Overview of the Links among Education, Training, and Workforce Development Policies," "The Virtues and Flaws of Implementing Welfare-to-Work," "The Labor Market Effects of Institutional and Structural Change," "Employment Policies for Urban America," and "Perspectives on a Policy Agenda for Employment and Economic Growth."

### William E. Curry

William E. Curry observed that at all levels of American government policy and politics have diverged; that is, policy advisers often do not consider the political and social ramifications of their proposals, and political advisers do not evaluate the content of the policies being proposed. Although each group has critical information, neither group understands the other. The intellectual quality of both groups has declined and both have been displaced by spin doctors, pollsters, consultants, phone bank operators, and fund raisers under whose influence politicians have become unable to distinguish between strategies of governance and strategies of self-presentation.

This divergence has also led to an atmosphere of uncertainty about the future political agenda. Aside from the campaign finance reform bill, there is, for the first time in a long time, no substantial institutional reform before Congress--no civil rights legislation or Medicare or environmental initiative. According to Curry, both parties have not understood the public's anger about how government operates and its inability to stand up for average working people and the disadvantaged, and both parties are burdened by an inability to reframe their view of the world. The Republicans are convinced that people want more tax cuts and deregulation. However, specific

changes that they have suggested have died a quick and public death because it appears that people are satisfied with the current size of government and feel that government has gone beyond an acceptable level of deregulation in terms of environmental protection and workplace safety. Democrats find that there is no constituency for the "silver bullet" approach to policy--enacting a statute, regulation, or tax to "fix" any given problem. Currently, then, we are not at the end of ideology, but of these two particular ideologies; we are in an age of intellectual uncertainty about what works and what does not work. To close this intellectual breach will require an enormous amount of intellectual work.

Curry asks whether the kinds of things that the (broadly defined) New Democrats have come to believe in--fiscal restraint, devolution, smallness in scale, public-private partnerships, and markets--fit with the orthodox progressive view, which seeks to extend the social contract, or with more recent concerns with redistribution of power and opportunity. The point of taking on such issues as balancing the budget and reconstructing welfare was to clear the boards and create a political stage on which institutional reform could take place. In Curry's opinion, the reform's failure to advance is not a reflection on the players' character, but on the state of the debate and the development of an intellectual response. "It is not that we don't have the courage of our convictions, but that we don't yet have the convictions to have courage for."

On employment issues, Curry suggested that portable pensions, portable health care benefits, and true lifelong learning programs would at least partially address the problems of wage stagnation and job insecurity, which he feels are tied to the high mobility of capital. Curry asserted that the social effects of technological change have been largely misinterpreted by government. Although some believe that technological change is in the hands of the private sector, Curry opined that government has a role to play. Like Theodore Roosevelt, who attempted to take on the concentration of power and cushion the effects of technological change, government today will have a role to play in influencing institutional reforms, although there is some confusion as to the exact shape these reforms might take. Political reform will be as key as technological change in increasing productivity.

According to Curry, "education solutions" will require more than setting standards. He suggested the establishment of community schools, with longer school hours, parental involvement in a democratic process, and the provision of resources by business and other institutions. Moreover, the social service bureaucracy needs to be transformed into an organization integrated by jurisdiction and function and affiliated with the school system. This requires that a few dollars be spent wisely on programs to restructure an institution so that it serves its beneficiaries. Because the era of big government is over, the resources necessary to implement successful change will have to come from business and the community and through more efficient spending of existing funds.

**S Jay Levy**

S Jay Levy noted that appraising consumer behavior is important in forecasting the trend of prices. He reminded the audience that inflation is about prices, which equal costs plus profits. Costs, aside from the costs of imports, are ultimately wages. Levy sees a current growing scarcity of workers, leading to some upward pressure on wages. But, profit margins will probably narrow instead of costs rising, so no acceleration of inflation is likely.

After a lengthy period of expansion, workers usually are little concerned about job insecurity and are eager for higher pay. However, in 1997, after more than six years of economic expansion, employees still appear to be more interested in job security than in wage hikes because of technological unemployment, foreign competition, relatively weak unions, and, of noteworthy importance, the absence of dismay at the checkout counter.

Technological advances are increasing job insecurity at an unprecedented pace. The latest devices replace white-collar as well as blue-collar workers. Moreover, advanced communication and transportation technologies have enabled businesses to take advantage of low wages in foreign countries. Management and workers both are aware that American firms must take advantage of low wages abroad because their foreign competitors are doing just that.

Increased productivity, especially in manufacturing, has led to smaller work forces and decreased union membership. Workers, especially in low-skill service jobs, often view their employment as temporary and are therefore less motivated to join unions than were assembly line workers in the past.

Dismay at the checkout counter, which in former times has spurred employees to demand higher pay, is noticeably absent. According to Levy, if consumers did find that the cost of feeding their families was rising faster than their wages, they would demand sizable raises. Today, however, shoppers find that consumer commodity prices are relatively stable. During 1994, 1995, and 1996 the consumer price index increased 2.5 percent, 2.5 percent, and 3.3 percent, respectively (with the 1996 advance largely reflecting a surge in petroleum prices). Because oil prices have lately been receding, the first-quarter 1997 gain in the CPI was 1.8 percent annual rate. The average annual rise in the CPI between 1993 and 1996 was 2.8 percent. Over the same three years, the average increase in the commodity component of the CPI was only 2.4 percent. (Levy believes that the commodity CPI better represents what consumers experience at the checkout counter than the whole CPI because the latter includes services prices.)

While the CPI was rising at an average annual rate of 2.8 percent and the commodity CPI at the rate of 2.4 percent, the average hourly wage was going up 3.2 percent, thereby increasing consumer purchasing power. Levy explained that labor costs per unit of output were rising less rapidly than wages because of reductions in fringe benefits and gains in productivity. Although the accuracy of productivity data is seriously questioned, he stated that he has little doubt that productivity gains for manufactured goods have been substantial.

Levy predicted that during the next two years we are likely to see profit margins narrow at least a little as the result of reductions in three sources of profits.[1] First, the federal government will move the budget deficit (a source of profits) toward zero. Second, the dollar likely will remain strong, thereby penalizing U.S. exports and encouraging imports. Thus, net foreign investment, at present a huge negative source of profits, is likely to reduce profits even further. Third, despite the fact that personal bankruptcies are occurring at a record rate and other evidence of consumer financial stress abounds, a substantial rise in personal saving, a negative profit source, is probable. Narrowing profit margins tend to discourage that critically important profit source, business investment in new plant and equipment.

Levy concluded by recommending the profits identity as a tool for anticipating changes in the profits component of prices and, indeed, for analyzing almost any macroeconomic problem.

**Note**

1. The "sources of profits" were first identified by Jerome Levy in 1908. They are components of the saving = investment identity.

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[Editor's note: The speakers' remarks and summaries of the sessions are to be published in the conference proceedings. To request a copy, call 914-758-7700 or 202-737-5389 (in Washington, D.C.), fax 914-758-1149, e-mail info@levy.org (be sure to include your mailing address in your message), or write The Jerome Levy Economics Institute of Bard College, Blithewood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000.]

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# Program 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.

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 in the distribution of human capital within the working-age population and document any changes in inequality, (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 underutilization 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 Jobs 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** focuses on 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. His results thus far imply a strong link between changes in the rates of labor market discourage-ment and changes in job opportunities, job quality, and educational requirements. 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 for Social Research. He is the author of Public Policy Brief No. 29, *Institutional Failure and the American Worker.*

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 Briefs 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** and Research Associate **L. Randall Wray** currently 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, as discussed in Public Policy Brief No. 27, *Targeting Inflation,* 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. Wray is an associate professor of economics at the University of Denver. He received a Ph.D. in economics from Washington University in St. Louis. Papadimitriou and Wray also are the authors of Public Policy Brief No. 15, *Monetary Policy Uncovered.*

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 East 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 East 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.

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# New Working Paper

### Disinflationary Monetary Policy and the Distribution of Income

**Willem Thorbecke**
**Working Paper No. 185, March 1997**

Some economists and others argue that, despite years of low inflation, a further decrease in the rate of price growth would be beneficial by reducing the dead-weight losses created by inflation-induced distortions. According to Research Associate Willem Thorbecke, of George Mason University, such arguments fail to consider the costs and benefits of changes in the distribution of income arising from deflationary policies. In this working paper, he examines the relative costs and benefits of such policies for firms (by size and sector) and workers (by income group and race).

Theoretically, contractionary monetary policy affects production through the traditional money channel by raising current and expected future values of the federal funds rate and, in turn, increasing long-term interest rates and reducing stock prices. The higher cost of capital should most affect production and workers in interest-sensitive industries, namely, industries that produce capital goods, housing, and durable goods. Monetary policy can also act through a credit channel by reducing firms' access to credit markets. As interest rates rise, cash flow positions (net of interest) worsen. Firms with weak balance sheet positions or restricted access to credit markets therefore experience a decline in working capital and reduced economic activity. It has been argued that smaller firms are more likely to have restricted avenues to credit; hence, contractionary monetary policies would more adversely affect smaller firms, with the effect greater during a recession than when the economy is growing.

The theory indicates that the distributional effects of contractionary monetary policy will fall on workers not only according to the industry in which they work, but according to income, skill level, and race. It has been argued that because unskilled workers have higher elasticities of labor supply, they will experience a sharper decline in employment than skilled workers during an economic slump that reduces wages. Similarly, during a downturn blue-collar jobs will be more adversely affected than white-collar jobs. Additionally, it has been found that income will be redistributed away from the bottom and toward the top as a result of contraction. Because African Americans tend to have lower in-comes than whites, "the brunt of contractionary monetary policy should fall on blacks and other minorities earning lower wages rather than on whites." On the other hand, a monetary contraction is expected to benefit bondholders and other creditors. Since it is wealthy households that tend to be creditors (while businesses, government, and poorer households tend to be debtors), it is these households that will benefit from a monetary contraction.

Using impulse response functions to examine the evidence of the effects of an unexpected rise in the federal funds rate, Thorbecke finds:

- Effects on employment peak after 18 months.
- Employment in construction and durable goods sectors is most adversely affected,[1] while employment in the nondurable goods, government, transportation, and mining sectors is barely affected.
- The rise in unemployment is higher for blacks and Hispanics than for whites.

Using the same methodology, Gertler and Gilchrist found that small firms' sales are reduced more than those of large firms.[2] Using a social accounting matrix, Thorbecke finds that a contraction is more harmful to non-union workers not covered by union contracts than to union or other workers. Since such non-union workers tend to have low-income jobs, those at the lower end of the income distribution are more adversely affected by contraction than higher-income workers. Additionally, Thorbecke finds a more detrimental effect on urban workers than on rural workers.

The consequences of the 1979 to 1982 "Volker deflation" lend credence to the theoretical arguments and the econometric results discussed above. Thorbecke finds that the durable goods and construction sectors were indeed most adversely affected in terms of unemployment (up 18 percent and 15 percent, respectively, with the next highest rise in unemployment in transportation, up 3 percent); that minority workers experienced higher rates of unemployment than did white workers; that small firms suffered more (in terms of profits and earnings) and over a longer period than large firms; and that the wealthiest 10 percent of households (which held nearly 95 percent of all bonds and trusts in 1982) benefited disproportionately following an almost 40

percent total return to bonds during that year. Thorbecke feels that, "given the economic difficulties facing lower-income families and the consequent threats to our society, engineering a disinflationary recession now would be inappropriate." The present time appears to present a good opportunity for allowing employment to grow.

### Notes

1. A one standard deviation (0.55 percentage point) decline in the interest rate was found to reduce employment by 0.7 percent in the construction sector and by 0.5 percent in the durable goods sector.

2. Mark Gertler and Simon Gilchrist, "Monetary Policy, Business Cycles, and the Behavior of Small Manufacturing Firms," *Quarterly Journal of Economics* 109 (1994): 310-338. Moreover, the sales response to monetary action was asymmetric for small firms (reducing sales in a recessionary contraction to a greater extent than they were raised in an expansion induced by monetary action), but not for large firms.

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# Conference

## Developments in the Financial System: National and International Perspectives

On April 10 and 11 the Levy Institute held its seventh annual conference organized under the aegis of its ongoing research program on restructuring in the financial services sector. Henceforth the conference will be called the Hyman P. Minsky Conference on Financial Structure in honor of the distinguished scholar who passed away last year.

Given the rapid globalization of finance and the connections between financial markets across borders, this year's conference focused on national and international perspectives on developments in the financial system. Featured speakers (whose comments are summarized below) were Charles Freedman, deputy governor of the Bank of Canada; James D. Kamihachi, senior deputy comptroller for economic and policy analysis at the Office of the Comptroller of the Currency, U.S. Department of the Treasury; Jack Metcalf, U.S. Representative (R-Wash.) and member of the House Committee on Banking and Financial Services; and Laurence H. Meyer, member of the Board of Governors of the Federal Reserve System. John D. Hawke Jr., undersecretary for domestic finance at the U.S. Department of the Treasury, was another featured speaker; his comments were off the record. Conference sessions were entitled "Financial Services Competition and Regulation," "Recent Developments in International Banking," "Consumer Finance, Debt, and Risk Management," "Federal Reserve Policy's Effects on the Efficiency and Stability of Financial Markets," and "Financial Services, Markets, and Public Policy."

### Charles Freedman

Charles Freedman noted that Canada's financial system, provides good examples of many banking sector innovations and an indication of what might happen in the United States should such innovations be implemented here. He identified three major areas in which the U.S. and Canadian financial systems differ: nationwide branching arrangements, reassessment and updating of banking legislation in the form of a sunset clause, and the timing of the elimination of interest rate ceilings on deposits and loans. He spoke about the background of the Canadian financial system, changes to the system that have occurred since the 1950s, and the effects of those changes on financial markets.

Thirty years ago the Canadian financial system consisted of five principal groups--charter banks, trust and mortgage loan companies, cooperative credit unions, life insurance companies, and securities dealers--characterized primarily by their core business activity and, to a lesser extent, by their incorporating and

supervisory jurisdiction (federal, provincial, or combined). Charter banks were mainly commercial lenders and deposit takers with substantial international business operations, but, over the years, they became important players in the personal loan and residential mortgage markets. Trust and mortgage loan companies tended to specialize in residential mortgage lending and, initially, in term deposits. The cooperative credit unions (more popular in English Canada than in French Canada) operated almost entirely under provincial jurisdiction and tended to deal in residential mortgages and personal loans offset by personal deposits. One important development over time has been the market-driven interpenetration of the groups into one another's core activities.

The five-year sunset provision included in all Canadian banking legislation requires that existing laws be reassessed and updated periodically. As a consequence of this periodic reconsideration, Canadian banking laws have changed to parallel market events. The Bank Act amendments of 1954, 1967, 1980, 1987, and 1992 were major legislative changes, all of which had the principal goals of increasing competition in the financial sector and had the key outcome of the gradual erosion of segmentation in the financial system. As a result of the 1954 amendments, which allowed banks to make personal loans secured by chattel mortgage and personal properties and to make insured mortgage loans, banks became major players in the household lending market. In 1967 the 6 percent interest rate ceiling on loans, which by then had begun to push banks out of the mortgage market, was eliminated. A rule restricting ownership of a domestic charter bank in Canada to 10 percent also was introduced. In 1980 banks were allowed to establish venture capital subsidiaries and wholly owned mortgage loan companies; foreign banks were for the first time allowed to establish subsidiaries, although subject to aggregate size restrictions; and the Canadian Payments Association Act allowed near banks to get involved in the administration of the payments business.[1] In 1987 the Canadian version of Glass-Steagall was essentially eliminated. The 1992 amendments continued to break down the traditional barriers between the groups of financial institutions, allowing them to enter one another's business. Proposed amendments for 1997 involve such issues as consumer privacy, allowing wholesale bankers to opt out of the deposit insurance agency, and permitting foreign banks, subject to certain conditions, to branch directly in Canada.

Discussing the outcomes of these legislative changes, Freedman explained that banks have lost some ground in their share of deposits, falling from approximately 75 percent in the 1970s to about 65 percent today. Their balance sheets differ in composition from those of U.S. banks. For example, mutual funds account for about 18 percent of U.S. bank deposits; in Canada, banks did not hold mutual funds until the 1990s and they account for only about 4.5 percent of total deposits. This difference can be attributed to the timing of the removal of interest rate ceilings in the two countries (1982 in the United States versus 1967 in Canada). The large spread between ceiling rates and market rates in the United States in the 1970s and early 1980s resulted in the development of money market funds, which allowed banks to attract deposits despite the ceiling. In Canada the absence of a ceiling when interest rates began to rise negated any motivation to switch to such instruments by consumers, who tend not to move their assets if the interest rate spread is only one or two percentage points.

Another outcome has been a difference in degree of securitization in the United States (about 50 percent) and Canada (about 4.5 percent). Freedman credited this difference to the countries' contrasting methods of financing mortgages. Although Canadian mortgages have a maturity of 25 years, they typically are subject to a 5-year rollover (at which time interest rates are revised). The short rollover term better allows banks to match the maturities of their deposits and assets. Furthermore, deposit insurance has a 5-year limit, which restricts the desire of consumers to hold deposits with maturities of any longer time period. Also, nationwide branching allows enough diversification to prevent undue exposure to regional economic variation.

As the result of the elimination of the Canadian equivalent of Glass-Steagall, the six major banks bought (or established *de novo* ) a major securities business. Before the legislative changes, the big (Schedule I) Canadian banks held 15 percent of the Treasury bill auction winnings and 90 percent of government bond auction winnings; today the figures are 62 percent and 50 percent, respectively. Banks have made major inroads into the mutual fund market, issuing approximately 68 percent of the total. Banks also now hold 55 percent of all mortgage funds.

Is such market concentration a problem? Freedman thought bank entry into the securities business was not because foreign securities dealers play an important role in stimulating competition. Of the 32 primary distributors of government bonds and bills, 13 are foreign owned; in 1996 they accounted for 70 percent of

Treasury bill auction winnings and 38 percent of bond auction winnings. However, banks have come to dominate activities in the trust market, which was not the original goal of deregulation. Banks bought out the largest trust companies when these companies encountered difficulties with their commercial real estate loans. Banks now hold $1.3 trillion in commercial real estate assets, or about 80 percent of the total market. Freedman opined that although trust companies were integral to competition in the financial sector, it was helpful that there was no legislative impediment to their takeover by banks when they encountered difficulties.

Freedman judged that changing conditions will present challenges to the Canadian banking industry during the next two decades: rapid technological advances, demographic changes, and increased competition with nonregulated financial firms for certain bank activities. Banks will have to make decisions about the extent and speed of their adoption of electronic banking, the degree of their involvement in the international economy, the areas in which they will focus their efforts (that is, which activities they can most efficiently perform, where they want to be niche players, and which areas they want to get out of altogether), and the desirability of growth by merger. With further developments in the next few years the entire financial sector is likely to change.

**James D. Kamihachi**

James D. Kamihachi discussed changes in financial institutions' "make or buy" decisions (whether to generate goods and services internally or to contract out for their production). Generally, a firm will base this decision on cost considerations. Any individual decision can be viewed as a tactic, but, consideration of all firms' make or buy decisions can reveal firms' underlying business strategy, such as a preference for vertical or horizontal integration. The production process in each industry generally will dictate whether it makes sense for the firm to integrate vertically.

The most familiar economy of scale presumed to result from vertical integration in commercial banking is an informational advantage provided by a combination of deposit and lending functions. It has long been thought that banks enjoy an informational advantage resulting from their administration of customers' deposit accounts, but this advantage has been eroded in recent years by the ability of nonbank lenders to obtain such information at relatively low cost. Vertical integration therefore has become less profitable for banks. It also requires substantial fiscal capital, high operating leverage, extensive coordination efforts, and expensive management expertise. Moreover, vertical integration can isolate a firm from market discipline, thereby reducing its flexibility.

Kamahachi opined that we often do not appreciate the degree to which commercial banks are vertically integrated. Typically, banks produce most of the inputs necessary to produce other financial services, and they own and operate the distribution networks for these services. For example, in the production of loans, banks underwrite and originate the loans themselves, finance the loans with core deposits rather than purchasing short-term funds in the open market, bear the credit risk of holding the loans on their books rather than securitizing them, and service the loans themselves rather than contracting the servicing out. Most banks own and operate their own distribution networks, made up primarily of free-standing brick-and-mortar branch facilities.

However, banks are not completely vertically integrated. They purchase deposit inputs and basic banking functions such as portfolio management, data processing, check clearing and collection, payroll, courier services, and the transportation and storage of currency and coin. Competitive pressures to reduce costs associated with reserve and capital requirements and the desire to move some interest rate risk and credit risk off their balance sheets are leading banks to increase dramatically the proportion of bank-originated loans that are securitized. In 1980 only 10 percent of mortgage loans were securitized; by 1994 almost half of all outstanding mortgage debt was securitized. Because modern mortgage banking exhibits large-scale economies, particularly in loan servicing, large-scale production guarantees that fewer banks will be making, and more banks will be buying, inputs related to lending. Banks also are changing delivery channels. Increasingly, banks are using ATMs not as profit centers but as a low-cost alternative for servicing their customers, making it less necessary for banks to own ATMs. Customers are increasingly using such services as ATMs (which communicate with banks using switches owned by nonbanks) and use banking software purchased from nonbanks, indicating further contracting out of services by banks.

Kamahachi noted that some evidence indicates that banks are becoming less vertically integrated. One of the most widely used measures of vertical integration--the ratio of value added to total revenues--has declined from an estimated 65.4 percent in 1960 to 32.8 percent in 1989 to 28.9 percent in 1995. The expansion of banks into fee-based businesses also may result in less vertical integration. Some evidence suggests that "contract" or "unbundled" banks may have a competitive edge over traditional banks. However, other developments are not compatible with the idea of reduced vertical integration: The number of branch locations (excluding ATMs) has risen during the 1990s, even as the number of banks has fallen; branches being established in supermarkets are providing the opportunity for an entirely new distribution channel; and many banks still are working to develop at-home computer banking channels despite the lag in the number of projected users.

How will banks produce financial services 20 years from now? According to Kamahachi, much depends on the economics of vertical integration. For example, technological change could restore to banks the information advantage that had been provided by the customer relationship, thereby slowing or reversing the trend away from vertical integration. However, prevailing forces appear to point in the opposite direction, toward continued unbundling with financial functions performed by specialized suppliers. The complexity and sophistication of modern financial functions, particularly in the area of risk management, make it more difficult to oversee the full range of bank products and processes, which suggests that unbundling will continue to displace vertical integration.

If banks continue to buy rather than make their services, the risk profiles of commercial banks are bound to change in unpredictable ways. Bank regulators face the challenge of determining how to allow banks to make these changes without decreasing the safety and soundness of the banking system. Bank supervisors must confront new and unfamiliar problems, such as the technological and legal issues involved in protecting customer privacy, the cultural issues involved in increased outsourcing by banks, and the rapid rate of increase in the pace of change. Kamahachi concluded that although many bankers and regulators are focusing their attention on new electronic money and banking products, "it will also be critical that we keep a weather eye on more mundane matters," such as the make or buy decision.

**Jack Metcalf**

Jack Metcalf spoke about the status and direction of federal banking legislation. Legislation that originated with Metcalf and has already been enacted places a chief examiner in charge when banks are examined by different regulatory agencies. Previously, banks might be examined by different agencies and were therefore subject to sometimes conflicting rules and regulations. The new law streamlines the regulatory process and prohibits contradictory recommendations that might confuse bank operations. Currently pending as a part of a comprehensive regulatory relief package being put together by the House Banking Committee is a bill that would allow the Federal Reserve to pay interest at federal fund rates on sterile reserves held by financial institutions at the central bank, thereby permitting institutions to opt to pay interest on corporate demand deposits.

Metcalf noted two broad areas slated for legislative change: the Glass-Steagall Act and financial modernization. Accord-ing to Metcalf, the depression-era restrictions included in Glass-Steagall have served a purpose, but recently they have prevented the U.S. financial services industry from changing with the times, thereby reducing its competitiveness in the international marketplace. New products and innovative approaches that were unimaginable in the 1930s are now introduced regularly, and inaction by Congress will not halt the change. Rather, the industry will look to the courts and regulators to provide access to activities seemingly prohibited under Glass-Steagall.

In the area of financial modernization a bill introduced this year by House Banking Committee Chairman Jim Leach outlines a holding company structure in which affiliations between holding companies, securities firms, and insurance agencies would be the norm and the Fed would have overall regulatory responsibility. (The bill was given a cool reception by many financial industry trade groups.) Senate Banking Committee Chairman Alfonse D'Amato also has a financial modernization bill that would allow wide affiliations between financial institutions and commerce. Representative Leach and Senator D'Amato hold divergent views on financial affiliations, specifically, on how involved in activities of commerce financial firms should be allowed to be. For example, under the D'Amato plan, a company like General Motors could own a bank, such as Citibank, and

also own a securities firm, such as Goldman Sachs. No longer would banking simply be a service to the general public and to commercial and industrial firms; instead, banks could become a part of these firms and could be owned by any diversified company. Metcalf stated that there is some concern in Congress that the D'Amato plan could result in the domination of the marketplace by very large firms. Some fear that these types of financial affiliations would allow commerce access to traditional banking arena benefits, such as the payment system, the discount window, and deposit insurance. Such access could come at a price to the consumer and must be managed accordingly. The objective must be to create a level playing field for the financial industry while keeping in mind the needs of the local community.

Many financial services are being allowed not through congressional action but through rulings by the courts and the Office of the Comptroller of the Currency. The OCC has moved to expand national bank powers into insurance, a move that has received the support of the Supreme Court. Battle lines thus have been drawn between the comptroller and the chairmen of both the Senate and the House Banking Committees. Congressional leaders will have a difficult time proving to the financial community that it will receive more from Congress than from the OCC. Metcalf noted that there may also be a constitutional question about which body has responsibility for affecting such change.

**Laurence H. Meyer**

Laurence H. Meyer discussed issues in financial modernization. Twenty years ago Regulation Q was still in effect, the Glass-Steagall Act was widely viewed as prohibiting mixing commercial and investment banking, interstate banking and branching were rare, and combining banking and insurance services was not even thought about. Today, concerns include the repeal of Glass-Steagall, the possibility of unlimited mixing of banking and commerce, expanded insurance activities for banking firms, and the entry of insurance and securities firms into banking.

Meyer began by noting that because the separation between banking and commerce never appeared complete, some observers contend that the two can be completely integrated. Advocates of unrestricted mixing of banking and commerce argue that such a combination would diversify risk for both commercial and banking firms, would provide synergies in cross-selling, could lead to more capital in the banking industry, and would help to solve problems related to asymmetric information and corporate control associated with commercial lending. Meyer finds little empirical support for these arguments in either the national experience or the experience abroad. Stock index mutual funds and evolving credit derivatives allow risk to be diversified in virtually any way a firm cares. Despite the fact that most people believe that at least some synergies in cross-selling exist, the (admittedly weak) literature on economies of scope in banking has been unable to find strong evidence of significant synergies. If the banking industry is viewed as vibrant and growing--which it is not unreasonable to do after five successive years of record profits--the industry should not have a problem attracting capital. Meyer conceded that there was some merit to the argument that mixing banking and commerce could reduce information costs in bank lending and facilitate monitoring and management control by the bank, but such internalization would come at a cost, such as less vibrant money and capital markets, an unwarranted expansion of the federal safety net, potentially dangerous conflicts of interest, and excessive concentration of power.

According to Meyer, the problem with mixing banking and commerce is that nonbanking financial firms are already affiliated with commercial firms--through the creation of financial subsidiaries by commercial firms and the acquisition of nonfinancial businesses by financial firms. If all financial firms are allowed to affiliate, but banking and commerce are prohibited from mixing, the preexisting commercial affiliates of nonbank financial firms would have to be divested to acquire a bank, while banks could enter *de novo* the new nonbank financial activity without divesting any valuable assets. Depending on your point of view, this is either inequitable or simply the cost of acquiring a bank, but it is a problem that must be addressed. The choices are divestiture, grandfathering, long-term phase-outs, basket clauses, or combining banking and commerce. Meyer feels it would be poor public policy to open up banking and commerce purely on grounds of equity; such a decision should be made on the basis of a disinterested analysis of net social benefits.

Meyer does feel that a strong case can be made for expanding the range of banks' permissible financial activities, in part because technological change has undermined traditional distinctions among financial products and services. Technology has altered the manner in which financial institutions both take and manage

risk in areas such as securitization, credit scoring, modeling for pricing and capital allocation, and, of course, creating derivatives. Derivatives allow the taking or hedging of risk and permit holders to combine and separate risks to mimic virtually any financial activity. They thus limit what regulators can prohibit, blur distinctions between instruments regulated by different regulators, and virtually eliminate functional and other distinctions among commercial banks, investment banks, insurance companies, and other financial institutions.

Meyer noted that new instruments and procedures raise questions about whether risk should be managed and supervised by instrument, legal entity, or both. Banking organizations have increasingly centralized risk management. New technology has created a supervisory imperative that financial modernization can only accelerate: the need to evaluate risk policies and positions centrally, most likely by one supervisor, sharing information with all legal entity regulators. However, Meyer was not sure about precisely what technological change implies for regulators: If units of an organization (legal entities) can simulate the attributes of a security or most of the risks and returns of certain businesses, what does the term "functional regulator" mean? How comfortable should the individual regulator feel if a hedge involves as counterparties two legal entities in the same failing organization? Will the regulator of a unit let the gains booked in that unit offset the losses in another unit regulated by a different entity? Can the regulator do so under the law? If the answer to either of the last two questions is no, what good is such a hedge at a failing organization? Even without complicating the issue by failure, how does the regulator of the unit booking the loss of the hedge feel about the hedge, no matter how desirable the hedge is for the whole organization?

To Meyer, the new reality is that supervisors have to supervise risk and not instruments or entities, which implies either that organizations cannot be allowed to undertake new activities or that we recognize that, over time, specialized regulators of banks, security firms, and even insurance companies are going to have to find a new paradigm. Any future supervisory structure will have at its center the evaluation of risk management procedures and policies. At a minimum, regulations should not be redundant. The necessarily intrusive supervision that comes with a safety net should not be extended to new activities. Such supervision would reduce efficiency and flexibility and would be unnecessary. More important, it could create a moral hazard by fostering the mistaken impression that a bank supervisor has confirmed the strength of the supervised affiliate.

Financial modernization also raises issues about organizational structure, issues closely linked to the subsidy provided by the safety net (deposit insurance and access to the Federal Reserve's discount window and payment system). The organizations that stand to gain the most from the safety net in times of crisis--those with the highest net subsidy and the strongest incentive to take excessive risks--are the most likely both to prefer and to take advantage of organizational structures that allow the greatest net subsidy. These are also the organizations that are most likely to start competitive relationships and expose taxpayers to considerable risk. Thus, while allowing organizations a choice of organizational structure certainly increases bank management's flexibility, it is not clear that allowing such a choice serves the public interest. Assuming that the goals of public policy are to not expand the safety net and to limit the opportunities for banks to exploit moral hazard incentives, the appropriate organizational form that future banking organizations should take will be one that minimizes safety net expansion and ensures bank safety and soundness. Meyer feels that the holding company structure has and can achieve both these goals.

### Note

1. Mortgage loan subsidiaries were exempted from reserve requirements; this exemption allowed banks to compete in the mortgage lending business with near banks, which had no reserve requirements. The aggregate size restrictions were never binding and were gradually eliminated; they were completely eliminated by the time of the free trade agreements with the United States. Until the passage of the payments act, the payments business was a monopoly of the Canadian Bankers Association.

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[Editor's note: The speakers' remarks and summaries of the sessions are to be published in the conference proceedings. To request a copy, call 914-758-7700 or 202-737-5389 (in Washington, D.C.), fax 914-758-1149, e-mail info@levy.org (be sure to include your mailing address in your message), or write The Jerome Levy Economics Institute of Bard College, Blithewood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000.]

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# Program Scholars

Research Associate **Steven M. Fazzari**'s current project (which also falls into the area of federal budget policy) is an empirical estimation of the relative importance of the channels through which fiscal policy affects investment. Fiscal policy may affect investment through its influences on (1) interest rates and the cost of capital, (2) the business cycle, and (3) firms' financial condition. Policies aimed at affecting interest rates-such as tax incentives, budget deficits, and saving incentives-are thought to influence investment by reducing the cost of capital. Policies aimed at influencing the business cycle are believed to have a short-term effect on the health of the economy and possibly a longer-term influence through investment effects. Finally, policies aimed at altering firms' financial condition-either through internal cash flow or through external debt-could affect the cash that firms use to finance investment internally or the health of the financial sector that provides investment finance through debt or equity issues. Fazzari's work will help direct policymakers' attention to those policies that seem to be most efficient at stimulating investment and, hence, economic growth. Fazzari is the author of Public Policy Briefs No. 9, *The Investment-Finance Link,* and, with **Benjamin Herzon**, No. 25, *Capital Gains Taxes and Economic Growth.* He is an associate professor of economics at Washington University in St. Louis. He received a Ph.D. in economics from Stanford 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 will trace 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.

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Two accounting-based models form the foundation of much of Distinguished Scholar **Wynne Godley's** research. The first model, the Levy Institute 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 are to be published as an annual Levy Institute publication. The second model, originally developed at Cambridge University, is a "closed" world model in which 12 trading blocks--of which the United States, China, Japan, and Europe are four--are represented. This model is based on a matrix in which each block's imports are described in terms of exports from the other 11 blocks. 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 Scholars **George W. McCarthy Jr.** and **Gennaro Zezza**, 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 author of Public Policy Brief No. 23, *A Critical Imbalance in U.S. Trade.* Godley is professor emeritus of applied economics at Cambridge University and a fellow of King's College.

Cambridge University Visiting Scholar **Andrew J. Paulson** is examining the social and economic contexts within which the European Union is progressing toward monetary union. In particular, Paulson compares the introduction of the Euro with the unification of currency in the United States at the turn of the century. In order to develop an analogy for Europe's policymakers, he will examine the effects of asymmetric shocks on individual regions in the wake of monetary union.

Cambridge University Visiting Scholar **Susannah Rodgers** is examining attitudes about privatization in Russia and other countries of the former Soviet Union. She will trace the evolution of opinions about the different forms of privatization introduced in the former Soviet Union while focusing on three themes: the historical experience of centrally planned economies, the particular structure of privatization that is adopted, and the perceived success or failure of such privatization. Rodgers hopes to shed light on the questions of why many Western firms remain so cautious in their investment in privatization (preferring instead to invest in joint ventures) and whether the citizens of these newly autonomous states are equally cautious in their perception of market reforms.

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# New Working Paper

## The Impact of Declining Union Membership on Voter Participation among Democrats

**Oren M. Levin-Waldman**
**Working Paper No. 193, July 1997**

The recent electoral victory that gave Republicans control of both houses of Congress for the first time in 40 years has been interpreted in two ways. One is that the victory reflects a major realignment of voter opinion. Voters dissatisfied with the party in power changed their party identification to the other party. The other interpretation is that the change in party power is better characterized as a dealignment of voters. Voters have not switched their party affiliation from Democrat to Republican as much as they have given up affiliation with any party and often have gone so far as not to participate in elections at all. Resident Scholar Oren M. Levin-Waldman contends that the decline of union membership in the United States caused voter participation to fall primarily among Democrats. The result has been a change in power by default: the Republican victory in 1994 had less to do with voter ideology than with voter participation.

Walter Dean Burnham (among others) characterized the 1994 Republican congressional victory as a full-scale realignment in which voter dissatisfaction with the Democrats grew until they were finally voted out of office. Proponents of the realignment theory cite the fact that the election brought to power a group of Republicans who ran on the Contract With America and voted with unprecedented solidarity for it. Proponents claim realignment is further supported by the observation that a more open nomination process in the Democratic Party had caused it to move to the left of its traditional base.

Levin-Waldman gives a number of reasons why these arguments are unconvincing. The Contract With America was a strong ideological statement, yet polls have shown that most people were not aware of its existence at the time of the election. The leftward movement of the Democratic Party explains why voters might have become dissatisfied with Democrats, but does not explain why they would be more comfortable voting for Republicans. Realignment requires a strong identification with the new party. This is inconsistent with several observed trends: a decrease in voter participation, an increase in ticket splitting, and a rise in the number of voters identifying themselves as independent. These trends point not to party realignment, but to general party decline.

To test his hypothesis, Levin-Waldman examined data from the National Election Studies cumulative file for party identification, union status, and voting among workers from 1952 to 1992. There was a decrease (from 59.0 percent to 47.5 percent) in voters identifying themselves as Democrats and an increase (from 31.6 percent to 39.4 percent) in those identifying themselves as Republican. The remainder did not identify themselves with either party. This change is consistent with the idea that there has been more of a dealignment than realignment. Union membership declined significantly over the 40-year period, from 32.1 percent to 19.6 percent of the working population. Levin-Waldman also found that union members are more likely to identify themselves as

Democrats and that the decrease in those who identified themselves as Democrats and the increase among those who identified themselves as Republicans were greater among those who were not union members than among those who were. Union membership was strongly associated with Democratic Party allegiance.

To test the effectiveness of unions in getting out the vote, Levin-Waldman constructed a least squares regression on the portion of the population who voted as a function of Democratic Party identification, independent identification, union membership, and a dummy variable for presidential elections. He found that union membership increases the probability of voting by 4.5 percent, a finding that is statistically significant at the 1 percent level. This reinforces his claim that the decline in union membership was a factor determining the decline of the Democratic Party. According to Levin-Waldman, the drop in union membership has affected considerably more than the distribution of income and economic power in the labor market. It has also affected the distribution of political power. Without labor unions, there is no effective counterweight in national politics to the influence of corporate interests.

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Senior Fellow **Walter M. Cadette**'s areas of special interest include health care, international trade, and regulation of financial institutions. He is currently examining proposals to put Social Security on long-run sound financial footing. 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 is author of Public Policy Brief No. 30, *Prescription for Health Care Policy.* He received an M.A. from Georgetown University and did further graduate work in economics and finance at New York University.

Cambridge University Visiting Scholar **David Seddon** is examining the effects of institutional shareholder activism on long-term corporate performance and behavior. He will focus on the role that the current corporate governance system has played in the shift toward maximizing shareholder value as the overriding goal of public corporations and on the consequences of this shift.

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## New Book by Resident Scholar Oren M. Levin-Waldman

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

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

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

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## Corrections

The article on the ASSA session on the work of Hyman P. Minsky (*Summary,* Spring 1997) contained two errors. First, the paper presented by Victoria Chick was not untitled; it was called "Some Reflections on Financial Fragility in Banking and Finance." Second, the paper presented by Charles J. Whalen (and recently published in the *Journal of Economic Issues*) was a paper written by Whalen alone; it was not Levy Institute Working Paper No. 165, written by Whalen and Minsky.

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