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For the Record

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Current Eco: Clippings

The OECD Economic Outlook

Highlights

OECD economies have now come out of recession. A number of them have for some time been growing sufficiently rapidly to bring down unemployment. And, on the assumption of some increase in short-term interest rates over the next year or so, the OECD projects steady growth, without a revival of inflation for the OECD area as a whole.[1]

The challenge now facing policy-makers is to sustain the current revival of non-inflationary growth and of employment as effectively as possible and to reduce the gap between aspirations for and realisation of economic and social well-being over the longer term. Meeting this challenge has three elements. First, it is crucial to consolidate trends towards price-stability through prudent management of monetary policy, and to provide a stable environment for private-sector decision-making. Second, it is necessary to make the best possible use of this recovery phase for fiscal consolidation, going beyond the improvement in public finances resulting from the cyclical recovery and reducing the structural element of budget deficits. One important benefit of fiscal consolidation should be a larger amount of national savings to be made available for private investment at lower costs. Third, governments should take full advantage of the current cyclical improvement in economic conditions to move forward with the agenda of structural reform, in particular to promote efficiency in product and labour markets, while meeting domestic and international social (equity) objectives.

It is difficult to establish firm benchmarks as to the timing and amount of policy tightening required to contain inflation pressures that may arise over the next year or two. Nevertheless, the following broad considerations for the orientation of monetary policy seem relevant:

- In the United States, where the economy is now running at about capacity, it is not clear whether the degree of monetary tightening which has taken place so far is sufficient to ensure a 'soft landing'. Preparedness to apply further restraint would appear to be the best policy posture at this point in the business cycle, as the risks from remaining too restrictive for a short period are less than those of allowing inflation to re-ignite.
- In the United Kingdom, Australia and New Zealand, where recoveries are fairly advanced, a process of monetary-policy tightening is also under way. But it is unclear that policies are yet sufficiently restrictive to ensure that inflation is kept low, even though output remains below capacity, because output is expanding rapidly. For the time being at least, there is a case for continuing with gradual monetary tightening until clear evidence emerges that any tendency for these economies to overheat is being avoided. In the case of Canada, another country where recovery is fairly advanced, the orientation of monetary policy will be influenced by financial market concern about the process of fiscal consolidation as well as developments in US interest rates and in the exchange rate.
- In Ireland and most Nordic countries, economies are also expanding strongly. Little inflation pressure is apparent in Ireland, Denmark or Norway. In Finland and Sweden, however, export sectors are experiencing high levels of demand which could have inflationary repercussions throughout the rest of their economies; monetary authorities have already moved to raise interest rates. All of these countries will have to be alert to the risk that any exchange-rate weakness could imply for inflation.
- In most other continental European countries, the judgement appears to be more finely balanced. Recovery is becoming well-established but capacity constraints do not appear likely to emerge in the near future. In Germany, which will have a key influence on European mone-tary policy more generally, inflation, while on a downward trend, is still somewhat higher than desired. This suggests that the scope for further easing is limited. On balance, this climate suggests no immediate case for a shift in policy, with risks, going into 1995, appearing fairly evenly balanced in both directions.
- In Japan, the appropriate time for moving rates to an upward path appears to be some way off, given that inflation is virtually non-existent, banks' balance sheets remain weak, further upward pressure on the yen would be unwelcome, and the economy is not yet growing fast enough to begin absorbing unused capacity.

A complication in the setting of monetary policy is concern about the possible adverse effects of the large increases in long-term interest rates since around the beginning of 1994. However, insofar as unexpected and nearly simultaneous increases in long-term interest rates across OECD countries can be associated with short-term prospects for OECD activity which have improved surprisingly rapidly since the beginning of the year – particularly in continental Europe – this is not a matter of disquiet. Furthermore, in many countries the current levels of 'real' interest rates (that is, nominal interest rates adjusted for inflation) do not appear to be significantly higher than the average over the period since 1980.

Nonetheless, the extent to which long-term interest rates have risen does point to underlying tensions. Some of the rise in nominal long-term interest rates is quite possibly due to a re-assessment and upward revision of private-sector inflation expectations. Market participants may not be as convinced as policy-makers that present low rates of inflation will be sustained: a 'credibility gap' may exist here. It can be reduced or eliminated only through a clear commitment of monetary authorities to consolidate the good price performance now evident in many OECD countries. This calls for an institutional framework conducive to sound monetary-policy decision-making. In this regard, ensuring the credibility of inflation targets, by helping to make the actions of monetary authorities more transparent, may have an important role to play in many countries.

In some countries, there may also have been a market re-assessment of the seriousness of the medium- and longer-term outlook for public finances.

1. ***OECD Economic Outlook*** *No. 56, OECD Publications, Paris, December 1994*

It is notable that some of the largest rises in long-term rates in the course of 1994 have been in countries where public debt is high and there has been concern about the ability of governments to achieve a sustained reduction of budget deficits. Market reaction here may also be linked to the assessment of inflation expectations: concern may linger that policy-makers could yield to the ever-present temptation to attempt debt reduction through inflation, thereby adding to risk premia embodied in long-term interest rates. Hence, a faster pace of fiscal consolidation, which would contribute to a higher level of national saving and tend to put downward pressure on interest rates, appears to be a crucial element in durably higher OECD growth.

Improving Public Finances

The average OECD general government deficit may narrow from a peak of 4[illegible]% of GDP in 1993 to below 3% by 1996. Although much of this improvement will be 'structural', reflecting progress in fiscal consolidation, the public-finance position will remain unsatisfactory in nearly all OECD countries. It is especially noteworthy that gross public debt as a percentage of GDP is likely to rise in virtually all OECD countries between 1993 and 1996. For the OECD as a whole, gross debt could increase from 68% of GDP in 1993 to close to 75% by 1996, and could be well above that average in Japan (nearly 90%), Italy (over 120%), Canada (over 95%), Belgium (around 135%), Greece (around 120%) and Sweden (around 110%). And, by the year 2000 public debt for the OECD as a whole should still be around current levels.

This medium-term outlook for public-sector financial positions strongly suggests that many countries have to review and strengthen their plans for fiscal consolidation. Furthermore, this outlook embodies sustained recovery and some falls in nominal long-term interest rates from their present levels. If these developments do not occur, average OECD public debt in the year 2000 would be significantly above current levels. In considering the appropriate degree of ambition to bring to fiscal consolidation, it should be noted that the Maastricht targets for EC countries are fairly modest: they should be seen as only a medium-term step on the longer-term road to sound public finances.

The specific measures to be taken to speed the pace of fiscal consolidation will have to be tailored to situations in individual countries, but governments in all countries will be concerned to take account of considerations of equity and the impact on living standards for low-income groups. In most cases, if not all, governments have recognised that the main effort will have to be made on the expenditure side. Increasing the overall level of taxation, which already creates significant distortions in most OECD countries, could generally have strong negative side-effects. As well, in making any changes on the tax side, care should be taken not to reverse the thrust of tax reforms that have been implemented in many OECD countries over the past decade or so – given that these reforms were designed to put in place a tax structure more conducive to improved economic performance. Tax revenues will rise as economies recover, but it is important not to interpret this cyclical development as a permanent (structural) improvement in public finances. By the same token, it is also important to recognise that proceeds from privatisation, although helpful in reducing financing requirements in the short run or redeeming debts, are capital receipts (that is, one-off financing items) that do not significantly improve the structural position.

On the expenditure side, however, reform confronts entrenched expectations and perceptions of acquired rights and implicit social contracts. Recent experience and work by the OECD provide some pointers to the specific forms corrective action could take:

- Whether or not it is possible – or desirable – to reduce the 'output' that many government programmes and services deliver to the public, it may well be feasible to reduce the cost of such output, that is, to improve 'micro-efficiency' in some areas. A good example of where such scope exists is health expenditure, an area in which major questions about the cost of services have been raised in many countries. More generally, the development of competitive environments in the public sector through recourse to market-type instruments such as user-charging, market-testing, contracting-out and the creation of internal markets, has allowed for more cost-effective provision of certain public services in a number of countries.
- Pension liabilities are increasingly being recognised as a long-term problem. Many countries are now attempting to assess which of a range of policy choices might most effectively and most acceptably reduce the burden of future liabilities on public finances. Countries are considering policy-responses including increasing the retirement age or the length of service required for full benefits, increasing contributions, re-

Table 1
Growth of Real GDP in the OECD Area
%

	Share in total OECD	Change from previous year			
	1991	1993	1994	1995	1996
United States	36.37	3.1	3.9	3.1	2.0
Japan	14.92	0.1	1.0	2.5	3.4
Germany	8.65	–1.1	2.8	2.8	3.5
France	6.59	–1.0	2.2	3.1	3.2
Italy	6.20	–0.7	2.2	2.7	2.9
United Kingdom	5.75	2.0	3.5	3.4	3.0
Canada	3.33	2.2	4.1	4.2	3.9
Total/average of above 7 countries	81.81	1.4	3.0	3.0	2.7
Australia	1.77	3.8	4.3	4.3	4.0
Austria	0.86	–0.3	2.6	3.0	3.1
Belgium	1.09	–1.7	2.3	3.0	3.1
Denmark	0.57	1.4	4.7	3.3	2.9
Finland	0.49	–2.0	3.5	4.8	3.9
Greece	0.62	–0.5	1.0	1.5	2.3
Iceland	0.03	0.9	1.9	1.6	2.0
Ireland	0.27	4.0	5.0	5.0	4.6
Luxembourg	0.05	0.3	2.6	3.2	3.5
Mexico	2.79	0.6	2.9	4.0	4.3
Netherlands	1.57	0.4	2.5	2.9	3.2
New Zealand	0.29	4.4	5.0	3.6	2.9
Norway	0.45	2.2	3.6	2.9	2.3
Portugal	0.57	–1.1	1.0	2.6	2.9
Spain	3.15	–1.0	1.7	2.9	3.3
Sweden	0.92	–2.1	2.3	2.3	2.5
Switzerland	0.94	–0.9	1.7	2.2	2.7
Turkey	1.74	5.9	-3.9	3.6	4.8
Total/average of above 18 countries	18.19	0.7	2.0	3.3	3.5
Total OECD	100.00	1.3	2.8	3.0	2.9
North America	42.49	2.9	3.9	3.2	2.3
OECD Europe	40.53	–0.1	2.3	3.0	3.2
EC	35.09	–0.3	2.5	3.0	3.2
Total/average OECD *less* the United States	63.63	0.2	2.2	3.0	3.4

ducing benefits and achieving (better) capitalisation.

• Many analysts (including the OECD Secretariat in the recently published *OECD Jobs Study*[2]) have reached the conclusion that a range of social transfers are achieving their fundamental and legitimate objectives but only very inefficiently. In some cases policies are close to being counter-productive, such as when they create dependency traps. There would appear to be scope for re-examining how basic social objectives could be achieved while reducing overall budget costs.

Improving Employment and Productivity

The appropriate setting of macro-economic policies provides the basis for improved economic performance over the longer term. Assuring a sustained improvement in employment and productivity, however, requires not only sound macro-economic conditions but also a broad range of structural reforms, including the creation of competitive and open markets. It is only when both macro-economic and structural policies are set appropriately that the synergies between them are fully exploited. These synergies will be necessary if OECD economies are to sustain rising living standards and to be in a position to achieve social objectives more satisfactorily. Among the range of structural actions embodied in this task, the most urgent are arguably those that increase employment and reduce unemployment and those that reinforce the benefits from international trade.

Employment Policies

A crucial area in which there has been inadequate progress is the implementation of structural reforms aimed at reducing unemployment to acceptable levels. The medium-term scenario presented below suggests that, on the basis of policies now in place and a full return to sustainable medium-term growth patterns, unemployment will still be unacceptably high in the year 2000 in most OECD countries; for OECD Europe as a whole it could still average close to 10%. The structural reforms to address this problem, identified in the *OECD Jobs Study*, have to cover both product and labour markets in order to strengthen the capacity of economies in OECD countries to adapt to changing conditions, to improve productivity performance and to generate more new jobs. Many measures to improve productivity and product market performance, such as those which would enhance the development and diffusion of technological know-how and remove impediments to the creation and expansion of enterprises, will also contribute to economic conditions which are favourable to job creation. Others, however, such as exposing sheltered industries to increased competition may lead to a labour shake-out and higher unemployment in the short term. This adds to the importance of measures to improve the way labour markets operate in an effort to make early progress in reducing unemployment on a durable basis.

In changing policies so as to improve the functioning of labour markets and thereby boost employment, policy-makers will also be concerned that legitimate social objectives are not undermined. In this connection, the focus may differ depending on the policy being assessed. For the purposes of taxation and means-testing for the payment of unemployment benefits, treating individuals separately from their family circumstances may be necessary to reduce the risks of poverty traps or of discouraging people from entering the labour force. But for a number of other purposes for which it is thought to be important to assess whether or not social objectives are being achieved, the focus should be on household incomes rather more than on wages of individuals. Situations in which low wages are earned by members of households with adequate income overall are not necessarily inconsistent with the equity objectives. This is especially the case if the low-wage jobs are the first jobs in the working life of the persons involved, allowing them to gain work experience and to obtain a foothold on the job ladder, thereby helping to provide the basis for moving up the ladder to higher-paid employment.

Table 2
Unemployment in the OECD Area[1]

	Thousands	% of labour force			
	1991	1993	1994	1995	1996
United States[2]	8,443	6.8	*6.1*	*5.6*	*5.6*
Japan	1,360	2.5	*2.9*	*3.0*	*2.9*
Germany	2,602	8.8	*9.6*	*9.1*	*8.6*
France	2,361	11.7	*12.6*	*12.3*	*11.7*
Italy[3]	2,654	10.4	*11.3*	*11.2*	*11.0*
United Kingdom	2,348	10.2	*9.4*	*8.7*	*7.9*
Canada	1,416	11.2	*10.5*	*9.7*	*9.2*
Total/average of above 7 countries	21,184	7.3	*7.2*	*6.8*	*6.6*
Australia	809	10.9	*9.7*	*8.7*	*7.9*
Austria	125	4.2	*4.4*	*4.2*	*4.1*
Belgium	391	11.9	*12.6*	*12.1*	*11.3*
Denmark	296	12.2	*12.0*	*10.8*	*10.1*
Finland	193	17.9	*18.3*	*16.3*	*14.6*
Greece	301	8.2	*9.7*	*10.0*	*10.2*
Iceland	2	4.3	*4.7*	*5.1*	*5.3*
Ireland	209	16.7	*15.8*	*15.3*	*14.7*
Luxembourg	2	2.1	*2.4*	*2.1*	*1.9*
Mexico[4]	322	3.5	*3.7*	*3.5*	*3.4*
Netherlands	490	8.3	*9.3*	*8.6*	*7.9*
New Zealand	168	9.5	*8.3*	*7.6*	*7.4*
Norway	116	6.0	*5.5*	*5.2*	*4.8*
Portugal	198	5.5	*6.8*	*6.8*	*6.7*
Spain	2,464	22.7	*24.3*	*24.0*	*23.4*
Sweden	122	8.2	*7.9*	*7.7*	*7.5*
Switzerland	39	4.5	*4.7*	*4.1*	*3.5*
Turkey[5]	1,547	8.7	*12.6*	*13.7*	*14.2*
Total/average of above 18 countries[6]	7,794	10.4	*11.5*	*11.4*	*11.1*
Total OECD[6]	28,978	8.0	*8.2*	*7.9*	*7.7*
North America[6]	10,181	6.9	*6.3*	*5.8*	*5.8*
OECD Europe	16,460	10.7	*11.6*	*11.3*	*10.9*
EC	14,315	11.2	*11.8*	*11.4*	*10.9*
Total/average OECD *less* United States[6]	20,535	8.6	*9.2*	*8.9*	*8.6*

Figures in *italics* are provisional.

1. Commonly used definition.
2. Break in series from January 1994.
3. Break in series in 1991 and 1992.
4. Figures based on the national survey of urban employment (32 urban zones and around 12 million people).
5. Important revisions to data.

Trade Policy

The conclusion of the Uruguay Round and the coming transformation of the General Agreement on Tariffs and Trade into the World Trade Organisation are potentially very positive events for the world economy.

2. *The OECD Jobs Study: Evidence and Explanations*, OECD Publications, Paris, 1994.

Table 3
Private Consumption Deflators in the OECD Area

%

	Change from previous year			
	1993	1994	1995	1996
United States	2.5	*2.2*	*3.1*	*3.6*
Japan	1.0	*0.8*	*0.5*	*0.6*
Germany	3.9	*2.6*	*2.1*	*2.2*
France	2.1	*1.8*	*1.6*	*1.7*
Italy	4.7	*3.9*	*3.3*	*3.1*
United Kingdom	3.5	*2.6*	*2.7*	*2.9*
Canada	1.7	*0.9*	*2.0*	*1.8*
Average of above 7 countries	2.6	*2.0*	*2.4*	*2.6*
Australia	1.9	*1.6*	*2.8*	*3.0*
Austria	3.6	*3.0*	*2.5*	*2.8*
Belgium	2.6	*2.5*	*2.3*	*2.4*
Denmark	1.7	*2.0*	*2.5*	*3.0*
Finland	3.9	*1.7*	*2.1*	*2.5*
Greece	13.6	*11.1*	*9.4*	*6.8*
Iceland	4.9	*1.6*	*1.7*	*1.7*
Ireland	1.6	*2.4*	*2.6*	*2.7*
Luxembourg	3.7	*2.4*	*2.1*	*2.3*
Mexico	9.8	*7.0*	*5.7*	*4.7*
Netherlands	2.1	*2.2*	*2.0*	*2.2*
New Zealand	1.4	*1.6*	*2.3*	*1.9*
Norway	1.9	*1.5*	*2.0*	*2.2*
Portugal	6.7	*5.3*	*4.2*	*4.0*
Spain	5.1	*4.7*	*3.8*	*2.9*
Sweden	6.1	*3.1*	*3.4*	*3.0*
Switzerland	3.0	*0.9*	*2.6*	*2.0*
Turkey	51.9	*110.0*	*50.0*	*28.0*
Average of above 18 countries	9.5	*14.0*	*8.1*	*5.6*
Average OECD	3.8	*4.2*	*3.4*	*3.1*
Average OECD *less Turkey*	3.0	*2.3*	*2.6*	*2.7*
North America	2.9	*2.4*	*3.2*	*3.5*
OECD Europe	5.9	*7.5*	*4.7*	*3.7*
OECD Europe *less Turkey*	3.8	*2.9*	*2.6*	*2.6*
EC	3.8	*3.0*	*2.6*	*2.6*
Average OECD *less United States*	4.6	*5.4*	*3.5*	*2.5*

Figures in *italics* are provisional.

But this potential will be realised only if the agreements are ratified, which on 1 December a number of key parties to the agreement had not yet done. The most important and urgent item on the trade policy agenda is thus this ratification.

On the assumption that ratification takes place, the progressive implementation of the commitments in the Final Act and the important built-in agenda for further negotiations (*inter alia* on services and agriculture) should keep up the trade liberalisation momentum. Under this new policy framework and with ongoing structural change in the international economy, some new trade issues have acquired prominence. Broadly speaking, these issues can be placed in two groups.

First, international differences in business practices and in policies which affect them (public procurement, competition and other aspects of business policy, openness to foreign investment and technology policy) can impinge on international trade in ways that are perceived to be 'unfair'. Even though these differences have narrowed, many issues remain to be resolved. International agreements to harmonise the legal and regulatory framework in which businesses operate can address this problem by eliminating divergences which work to the advantage or disadvantage of businesses in particular countries. Yet it is important to bear in mind that a framework which minimises the amount of change that is required in many countries is not necessarily the best. The challenge for governments is to achieve a consensus on where harmonisation would be helpful and, in such cases, to identify a set of rules that will increase the contestability of the markets concerned.

Second, pressures are increasing to use trade policy to further other policy objectives, in particular those relating to labour standards and the environment. It would clearly be inappropriate to use restrictive trade policies to offset the effect of lower wages, as this would deny the benefits of comparative advantage to both the developed and the developing world. On the other hand, there may be a small set of 'core' labour standards based on fundamental human and civil rights – although to date the International Labour Organisation has been unable to agree on which of many conventions would constitute such a set – which prohibit practices, such as forced labour, that the international community finds unacceptable. Pressures are also increasing to use trade policy to further environmental objectives. It may take time to reach consensus on areas of disagreement, including free-rider problems in the context of global environmental agreements. It is nonetheless important that governments find a multilateral approach which ensures that these issues are not used as a pretext for protectionist practices.

Table 4
Current Balances in the OECD Area

% of GDP

	1993	1994	1995	1996
United States	–1.6	*–2.3*	*–2.4*	*–2.3*
Japan	3.1	*3.0*	*2.8*	*2.6*
Germany	–1.1	*–1.2*	*–0.6*	*–0.5*
France	0.8	*0.7*	*0.8*	*1.0*
Italy	1.2	*1.6*	*2.1*	*2.5*
United Kingdom	–1.7	*–0.9*	*–1.1*	*–1.4*
Canada	–4.3	*–3.9*	*–3.3*	*–3.0*
Average of above 7 countries	–0.1	*–0.3*	*–0.2*	*–0.2*
Australia	–3.9	*–4.0*	*–4.9*	*–4.9*
Austria	–0.5	*–0.8*	*–1.1*	*–1.2*
Belgium-Luxembourg	5.7	*5.7*	*6.3*	*6.7*
Denmark	4.1	*2.3*	*2.0*	*2.6*
Finland	–1.1	*2.4*	*2.8*	*2.9*
Greece	–0.9	*–0.8*	*–1.1*	*–1.4*
Iceland	0.1	*0.7*	*0.6*	*0.7*
Ireland	7.9	*7.9*	*7.8*	*8.4*
Mexico	–6.2	*–6.6*	*–7.2*	*–7.6*
Netherlands	3.3	*3.3*	*3.8*	*4.0*
New Zealand	–2.1	*–2.4*	*–2.0*	*–1.2*
Norway	2.3	*2.4*	*2.4*	*3.0*
Portugal	–0.2	*–1.6*	*–0.6*	*–0.5*
Spain	–1.1	*–1.0*	*–1.1*	*–1.2*
Sweden	–0.9	*1.1*	*2.3*	*3.4*
Switzerland	8.0	*6.2*	*6.8*	*6.7*
Turkey	–3.9	*1.3*	*2.3*	*3.0*
Average of above 18 countries	0.1	*0.3*	*0.5*	*0.6*
Average OECD	0.0	*–0.2*	*–0.1*	*0.0*
North America	–2.1	*–2.6*	*–2.7*	*–2.6*
OECD Europe	0.3	*0.5*	*0.8*	*1.0*
EC	0.2	*0.2*	*0.5*	*0.6*
Average OECD *less United States*	0.7	*0.9*	*1.0*	*1.0*

Figures in *italics* are provisional.

1 December 1994

Companies Merge; Families Break Up

Bill Russell

By Lester C. Thurow

No country without a revolution or a military defeat and subsequent occupation has ever experienced such a sharp a shift in the distribution of earnings as America has in the last generation. At no other time have median wages of American men fallen for more than two decades. Never before have a majority of American workers suffered real wage reductions while the per capita domestic product was advancing.

So on Labor Day this year, as with a lot of Labor Days, most laborers don't have a lot to celebrate. The median real wage for full-time male workers has fallen from $34,048 in 1973 to $30,407 in 1993.

Wages of white men are falling slightly faster than those of black men, and the young have been clobbered: wages are down 25 percent for men 25 to 34 years of age. Median wages for women didn't start to fall until 1989, but are now falling for every group except college-educated women. The pace of decline seems to have doubled in 1994 and early 1995.

The tide rose (the real per capita gross domestic product went up 29 percent between 1973 and 1993), but 80 percent of the boats sank. Among men, the top 20 percent of the labor force has been winning all of the country's wage increases for more than two decades.

Adding to the frustrations, the old remedy for lower wages — more education — no longer works. True, wages of males with only a high-school education are falling faster than the pay of those with college degrees. But investing in a college education doesn't get one off the down escalator and onto an up escalator — it merely slows one's descent.

No one knows exactly how much of the decline can be traced to any particular cause, but we do know the set of causes that has been responsible.

New production and distribution technologies require a much better-educated work force. If decisions are to be pushed down the corporate hierarchy, those at lower levels have to have skills and competency beyond what was required in the past.

> In the modern economy, men have strong *incentives* to bail out.

With our global economy, where anything can be made anywhere and sold everywhere, the supply of cheap, often well-educated labor in the third world is having a big effect on first-world wages. One month's wages for a Seattle software engineer gets the same company an equally good engineer in Bangalor, India, for a year. Ten million immigrants entered the United States during the last decade, competing for jobs and lowering wages.

American companies are moving production overseas, using new technology to replace workers, engaging in mega-mergers such as this week's Chase-Chemical deal, and otherwise downsizing. Each year more than a half-million good jobs are eliminated by the nation's most prestigious companies. More new jobs are being generated in the service sector, but they come with lower wages and fewer fringe benefits.

With the death of Communism and, later, market socialism as economic alternatives, capitalists have been able to employ more ruthless approaches to getting maximum profits without worrying about political pressure. "Survival of the fittest" capitalism is on the march.

What economists call "efficiency wages" (a company paying higher salaries than the minimum it needs to pay, so that it gets a skilled, cooperative, loyal work force) are disappearing to be replaced by a different form of motivation — the fear of losing one's job.

Falling real wages have put the traditional American family into play, as the one-earner middle-class family becomes extinct. With children needing ever-more-costly educations for ever-longer periods of time, the cost of supporting a family is rising sharply just as earnings plunge.

Thirty-two percent of all men between 25 and 34 years of age earn less than the amount necessary to keep a family of four above the poverty line. Mothers have to work longer hours if the family is to have its old standard of living.

Children exist but no one takes care of them. Parents are spending 40 percent less time with their children than they did 30 years ago. More than two million children under the age of 13 have no adult supervision either before or after school. Paying for day care would use up all or most of a mother's wages.

In the agricultural era, children had real economic value at a very early age, especially during planting and harvesting time. Parents knew that their children were their only pension system. For both parents and children the family was the social welfare net. One supported the family, and left it only reluctantly, since it was difficult to survive without it.

Using the language of capitalism in today's economy, children have shifted from being "profit centers" to being "cost centers." To support them, parents have to be willing to make large economic sacrifices. Men have a strong economic incentive to bail out of family responsibilities since when they do so their real standard of living rises 73 percent — although that of the family left behind falls 42 percent.

Whether it is fathering a family without being willing to be a father, whether it is divorce and being unwilling to pay alimony or child support, or whether it is being an immigrant from the third world and after a time failing to send payments to the family back home, men all around the world are opting out. (The Japanese seems to be the only exception.)

If mothers were willing to bail out, they too could have a higher standard of living. Often children would have a higher standard of living in foster care.

People support the family less because it is now much less necessary to their personal economic survival. People do not work as a family. Often they seldom see each other, given conflicting work and education schedules. Students who use college loans owe their parents less. Living thousands of miles apart, families lose track of one another. The family is no longer the social welfare system when one is disabled, old or sick, and it will not resume these duties even if the state were to withdraw.

The traditional family is being destroyed not by misguided social welfare programs coming from Washington (although there are some Government initiatives that have undermined family structure) but by a modern economic system that is not congruent with "family values."

Beside falling real wages, America's other economic problems pale into insignificance. The remedies lie in major public and private investments in research and development and in creating skilled workers to insure that tomorrow's high-wage, brain-power industries generate much of their employment in the United States.

Yet if one looks at the weak policy proposals of both Democrats and Republicans, "it is a tale, told by an idiot, full of sound and fury, signifying nothing." □

Lester C. Thurow is a professor of economics at the Massachusetts Institute of Technology.

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combined with systematic efforts to measure results. In such a world, the role of state and local bureaucrats would "change from manager to coach." Schools within school districts and teachers within schools would have far greater freedom, but would also be subject to far greater accountability.

Dale W. Jorgenson, an economist at Harvard who is not a member of the panel, likened the Hanushek approach to "market socialism" in contrast with the existing system of "regulated monopoly." The idea is to simulate competitive markets where they don't (and perhaps should not) exist. What Mr. Jorgenson does not quite say is that market socialism was a bust in Hungary and Yugoslavia because the incentives were hopelessly compromised by the ability of the losers to appeal the consequences to higher authority. Inefficient enterprises were inevitably bailed out to save jobs and face — a result, by analogy, that might be expected in public education as long as politicians and bureaucrats have the last word.

More specific criticism comes from Richard J. Murnane, another economist at Harvard. While he is entirely sympathetic with the thrust of the approach, he says "it is much harder to get the incentives right" than Mr. Hanushek suggests. He fears, for example, that teachers would teach for the standardized tests, giving short shrift to unquantifiable skills or goals like good citizenship.

Mr. Murnane also wonders whether decentralization does not create its own trap, sacrificing the potential benefits of professionalism because the current rigid system run by professionals has failed. "We'd be asking teachers to do things they don't know how to do," he said.

• • •

What virtually all economists seem to agree on is that there has been scandalously little attention paid to measuring cause and effect. Public education has been a wasteland for research, Mr. Murnane argues, in large part because the good folks paying the bills are not interested in unpleasant answers. It is, of course, an open question whether they are about to become more interested.

Bank Rescued in Japan In Sign of Deeper Woes

By JAMES STERNGOLD

Special to The New York Times

TOKYO, Oct. 12 — In a sign of the deepening troubles in Japan's battered financial system, the Mitsubishi Bank today announced its second major rescue operation in two weeks, saying it would spend at least $2 billion to take control of a collapsing bank, the Nippon Trust Bank.

Even though the announcement had been expected, since the trust bank's problems with bad real estate loans have been well publicized, the news provided grim evidence of the worsening plight of the Japanese banking system. The Finance Ministry has resisted allowing any banks to fail, or disclosing adequate information on the depth of the bad-debt problems, so today's announcement represented an uncommonly open admission that the situation was still getting worse.

Like other major banks here, the Mitsubishi Bank has had to announce several rescue operations. On Sept. 30, it said it was investing more than $1 billion to rescue two affiliated finance companies that had also run into problems because of bad real estate loans.

Today, the Mitsubishi Bank said it would purchase 443.4 million new shares of the Nippon Trust Bank for 450 yen each, for a total of slightly less than $2 billion. That will raise the Mitsubishi Bank's stake to 70 percent from slightly less than 5 percent when the deal closes on Nov. 11. It will slash by more than half the control that the current shareholders have over the trust bank.

"We made this difficult decision after a request for a rescue from Nippon Trust Bank and the authorities," Tsuneo Wakai, the Mitsubishi Bank's president, said at a news conference.

It has been reported that the Mitsubishi Bank will also have to absorb hundreds of millions of dollars of bad real estate loans from the trust bank, the heart of the problem afflicting Japan's financial sector, but neither of the banks confirmed the reports today.

The Nippon Trust Bank said it expected to report a $1.6 billion loss in the fiscal year that ends March 31. Tomoaki Hirano, the Nippon Trust Bank's president, said, "We have come to the conclusion that asking for outside support is the only way we can survive."

He added that even with the might of the Mitsubishi Bank behind it the Nippon Trust Bank was unlikely to report a profit or to pay a dividend for three years.

There was more evidence today of the sorry state of the banks. Japan's 11 largest banks announced that their total loan balance declined in September for the ninth straight month, a sign that the deflationary forces depressing real estate prices have not relented and that the banks are still not contributing to the economy's nascent recovery.

The takeover will allow the Mitsubishi Bank to become a force in the trust banking business, an area that until recently was off limits to commercial banks. But it is paying a steep price for the privilege. Analysts interpreted the takeover as a millstone around the neck of one of Japan's soundest banks.

A rare admission in Tokyo that the plight of banks is worsening.

"Nippon Trust Bank itself is unlikely to be in a position to yield any significant return on Mitsubishi Bank's investment for the foreseeable future," said Alicia Ogawa, the banking analyst at Salomon Brothers Asia.

Although the Mitsubishi Bank owns only 5 percent of the Nippon Trust Bank, the two have been close for some time. Mr. Hirano is the fifth consecutive president to have been drawn from the ranks of Mitsubishi Bank's executives.

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pliance with clean-air rules. Indeed, a leak from a U.S. Steel coke oven near Pittsburgh on Tuesday forced the company to temporarily evacuate 23 workers.

Because of a shortage of high-quality scrap and because of the emissions problems with coke ovens and blast furnaces, steel companies have been investigating new ways of transforming iron ore to steel.

Nucor has invested about $70 million in a plant in Trinidad that is to convert iron ore, which is mostly iron oxide, into iron carbide, which can be used as a substitute for scrap ...

COMPANY INDEX

Page numbers refer to the beginnings of articles. A dagger (†) denotes a parent company not directly mentioned in an article about a subsidiary. "ER" in the page column refers to an entry in the Company Earnings report, which today begins on page D5.

A

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Geneva Steel ....

Low Ranking for Poor American Children

U.S. Youth Among Worst Off in Study of 18 Industrialized Nations

By KEITH BRADSHER

WASHINGTON, Aug. 13 — Poor children in the United States are poorer than the children in most other Western industrialized nations, as young Americans suffer the brunt of several trends toward greater economic inequality, a new study shows.

Only in Israel and Ireland are poor children worse off than poor American youths, according to the study, an analysis of 18 nations by the Luxembourg Income Study, a nonprofit group based in Walferdange, Luxembourg.

The results are the most comprehensive of several recent analyses, and are particularly striking because the United States has the second highest level of economic output per person of the countries examined, after Luxembourg itself, and has the most prosperous affluent children of any of the 18 nations.

It may not be surprising that childhood poverty is worse in the United States than in Scandinavia, where governments have racked up huge national debts while trying to maintain elaborate social safety nets. But the United States also ranks below countries like Italy, which has a considerably smaller economy per person and has less generous social policies than many northern European nations.

The United States appears to have sunk through the rankings over the last 30 years, although no conclusive data are available now, said Timothy M. Smeeding, one of the study's

Data add to the debate over the future of Federal welfare programs.

authors and director of the Luxembourg Income Study. The American lead in overall prosperity has dwindled since the 1960's, income inequality has risen briskly in the United States and child poverty spread here in the 1970's and 1980's, although it may have leveled off in the early part of this decade.

Child poverty has also risen in Britain and Israel, while showing relatively little change in Continental Europe, according to the latest study.

Some conservative economists

rearing and education: to raise incomes."

Mr. Smeeding said there appeared to be several reasons why the United States had such extreme poverty among children.

The United States has the widest gap between rich and poor, he said. The United States also has less generous social programs than the other 17 countries in the study, which are Australia, Canada, Israel, and 14 European countries: Austria, Belgium, Britain, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Sweden and Switzerland. The study did not include several Western European nations like Greece, Spain and Portugal that have very poor children but limited data.

American households with children tend to be less affluent than the average American household, a pattern that is not true in many other countries.

This trend may reflect that American mothers are less likely than European mothers to return to work quickly after childbirth, partly because inexpensive, high-quality child care is more widely available in Europe, said Lee Rainwater, the research director of the Luxembourg Income Study and the co-author with Mr. Smeeding of the latest report. The Luxembourg group sent copies of the report to prominent social researchers last week and will make it more broadly available in the coming days.

Some conservative analysts question whether international comparisons of prosperity should even be attempted. They point to the many differences among nations' economies and societies.

There are more poor children in the United States than in many affluent countries, but that partly reflects the high number of poor immigrants and unwed teen-age mothers here, said Douglas J. Besharov, a resident scholar at the American Economic Institute, a conservative research group here.

"Is there more poverty in a big, diverse country like ours than in Western Europe?" he asked. "The answer is yes."

He and other conservative economists argue that the price the other countries pay for avoiding extremes of childhood poverty may be slower economic growth, which, they assert, leads to lower living standards for all. A large chunk of European social assistance to young families takes the form of generous unemployment benefits that have eroded incentives for people to work. Mr. Besharov

available in many European countries.

Sheila B. Kamerman, a professor of social policy and planning at Columbia University, said that for this reason, the latest analysis may have underestimated the extent to which poor American children lag in income. "If you were looking at in-kind benefits as well as cash benefits, the situation in the U.S. would look even worse," she said.

Professor Kamerman and Alfred J. Kahn, another Columbia University social policy professor, published a lengthy study two weeks ago reviewing social programs in Britain, Denmark, Finland, France, Germany, Italy and the United States and found that American poor children received the least help.

Poor children in Denmark do particularly well in comparison to poor American children. Vita Pruzan, the director of the children, youth and family research division at the National Institute of Social Research in Copenhagen, said in a telephone interview that in reducing child poverty, the Danish Government had found it particularly effective to provide free obstetric and nursing services.

Denmark also makes a particular effort to help single mothers who do not receive child support payments from the fathers of their children. "If the father is absent and doesn't pay, the state will pay what he is supposed to pay," Dr. Pruzan said. "The state tries to collect the money from the father, but that is not her problem."

SORTING IT OUT

The Gap Between Rich and Poor Children

The latest research indicates that poor children in the United States are poorer than the children in most other Western industrialized nations because the gap between rich and poor is particularly large in the United States and because welfare programs here are less generous than abroad. Households with children in the United States also tend to have lower incomes than the national average, a pattern that is not true in many other nations.

The bars at right represent the gap between rich and poor children in Western countries for which detailed data are available. The left end of a bar is the household income of poor children; the right end, affluent children. All figures are in 1991 dollars, with foreign currencies converted using adjustments for national differences in purchasing power.

	Poor household with children[1]	Affluent households with children[2]
Switzerland	$18,829	$59,502
Sweden	18,829	46,152
Finland	17,303	41,991
Denmark	17,268	46,326
Belgium	16,679	47,262
Norway	16,575	43,829
Luxembourg	15,396	50,071
Germany	15,257	51,874
Netherlands	14,529	42,616
Austria	14,321	39,911
Canada	13,662	56,174
France	13,003	44,835
Italy	12,552	44,280
Britian	11,581	43,933
Australia	11,512	49,863
United States	**10,923**	**65,536**
Israel	7,871	33,392
Ireland	6,692	27,185

Length of bars represent the gap between rich and poor children: $0 $20,000 $40,000 $60,000

[1] After-tax income, including Government benefits like food stamps or the Earned Income Tax Credit, for a family of four that includes children and that is poorer than 90 percent of the households in the country and more affluent than 10 percent of the households.

[2] After-tax income, including any Government benefits, for a family of four that includes children and that is more affluent than 90 percent of the households in the country and poorer than 10 percent of the households.

Source: Luxembourg Income Study

Poor children in Italy are also better off than poor American children, even though the median income in Italy is considerably less than in the United States. Free child care for some poor children and a low-cost health care system have helped, said Patrizia Ghedini, the head of the family issues department of the regional government for the area of northern Italy around Bologna.

But in Italy, the gap separating rich and poor is also smaller than in the United States. According to the Luxembourg Income Study report, a poor household with children near the bottom of the income scale in Italy earned $12,552 in 1991, while an affluent household with children near the top of the scale earned about $44,280. For the United States, the comparable figures that year were $10,923 and $65,536.

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have questioned the validity of studies that attempt to compare levels of income and distribution of wealth among nations with somewhat different economic systems and societies. There is general acceptance within the field, however, of the idea that the United States has proportionately more of its children in poverty than other affluent countries. The debate revolves instead around what to do about it.

The results of the Luxembourg Income Study report, which is based on census survey data from the various countries, are consistent with less statistically detailed work by other social scientists.

The study comes as Congress is deciding whether to limit Federal spending on various welfare programs. Senator Bob Dole of Kansas, the majority leader, tried to push welfare legislation through the Senate last week, but ended up postponing action until after Labor Day following strong resistance from Democrats and from conservatives within his party.

During a press conference on Thursday, President Clinton expressed strong concern about stagnant incomes, particularly for less-affluent Americans. "We've got to grow the economy and raise incomes," he said. "That's why I want to raise the minimum wage, that's why I want to give every unemployed worker or underemployed worker the right to two years of education at the local community college, that's why I'm trying to have a tax cut that's focused on child said.

The Luxembourg Income Study is financed by the National Science Foundation in Washington and similar agencies from 18 other governments. Its staff has been working for the last decade to develop ways to make reliable international comparisons. The group is a repository for computerized data on income distribution from 25 countries around the world, which it makes available for free to social researchers.

In addition to his work with the study, Mr. Smeeding is an economics professor at Syracuse University and one of the nation's leading experts on income calculations. While he personally favors expanded social spending in the United States, he is generally regarded in the field as an undogmatic thinker. Mr. Rainwater is a professor emeritus of sociology at Harvard University and the author of many books on poverty.

Their study is critical of Republican efforts to cut American social spending now.

The study compares incomes of poor and affluent households with children. The figures include not only after-tax wages and other personal income but also cash benefits from the government, like food stamps and the tax credit on earned income for low-income working parents with children. The calculations take into account differences among countries in the size of families and in the cost of living.

The figures do not include free government services, like the free medical and child-care services

Blast Suspect's Sister Says F.B.I. Used Fear Tactics in Questioning

By The Associated Press

Jennifer McVeigh, the sister of a suspect in the Oklahoma City bombing, says F.B.I. agents used fear tactics and showed her pictures of burned, dead children to pressure her into talking about her brother's activities, Time magazine has reported.

"They played a lot of games with me, a lot of things to get me talking," she told the magazine in its Aug. 21 issue, which is out today.

She added: "They totally broke me down. I thought I could handle it on my own. I guess I couldn't."

Later in the interview she said: "I didn't have time to think things out. It was constant pressure altogether."

Timothy J. McVeigh and Terry L. Nichols were indicted last week in the bombing of the Federal Building in Oklahoma City. The attack, on April 19, killed 167 people. Their former Army friend, Michael Fortier, pleaded guilty to lesser charges and has agreed to testify against them.

Although Time said Ms. McVeigh, 21, remained "fiercely loyal" to her brother, she cooperated with Federal prosecutors and provided two typewritten statements about her brother's activities.

The magazine interviewed Ms. McVeigh and her father, William, after agreeing not to ask questions about their grand jury testimony and about details of Mr. McVeigh's past.

"They showed me pictures of burned, dead kids," Ms. McVeigh told the magazine. "They put me and my mother in this room with all these huge posters with my name and a picture all blown up with all these possible charges against me ... like life imprisonment, death penalty and this and that. My mother was in tears when we walked away; they just crushed her."

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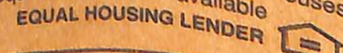
EQUAL HOUSING LENDER 

Flat Wages Seen as Issue In '96 Vote

Only the Wealthy Can Claim Gains

By LOUIS UCHITELLE

Wage stagnation, which has persistently held down the living standards of tens of millions of Americans, is finally emerging as a big economic issue for both Democrats and Republicans as the 1996 election campaign gets under way.

The Clinton Administration, in particular, is pushing the issue, convinced that by emphatically recognizing the problem, the Democrats can win back votes lost to Republicans in last November's Congressional election. And both parties recognize that wage stagnation is at the heart of the debate over the budget.

"You need to make wages a major campaign issue," said Laura D'Andrea Tyson, chief of the President's National Economic Council. She noted that President Clinton frequently refers to wages in his speeches and public remarks. He argues that he has presided over the revival of the economy and the creation of millions of new jobs, and that the task now is to create a strategy to make wages grow again.

"If the Republicans are speaking of this problem, we identified it for them," Ms. Tyson said.

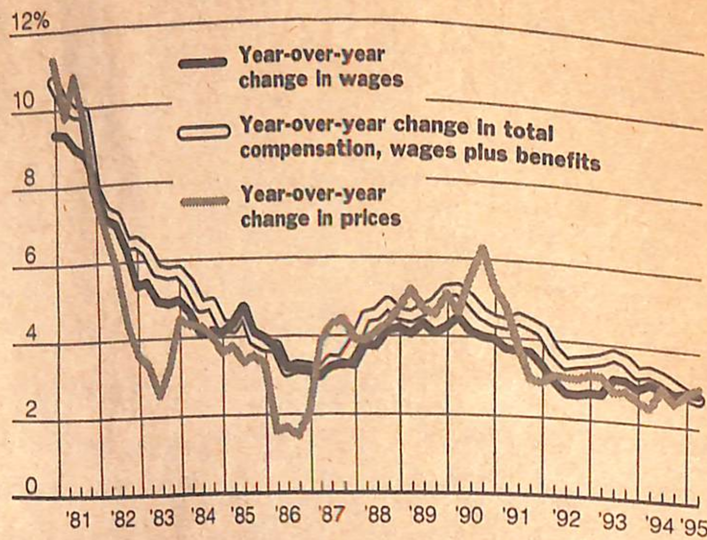
The Republicans are certainly speaking of the problem, and a common response is emerging from party leaders: that Mr. Clinton lacks a solution to the problem. "If he is suggesting that he is politically impotent on this huge issue," said Tony Blankley, a spokesman for Representative Newt Gingrich, the House Speaker, "then he is opening himself up to the argument that he should hand over the Presidency to someone who isn't impotent."

The problem with wage stagnation as a campaign issue is that there is no ready solution. And campaign issues without ready solutions do not easily sway voters, says James Carville, President Clinton's chief strategist in the 1992 election, who coined the slogan, "It's the economy, stupid."

It's not that Mr. Carville fails to recognize the importance of wage stagnation. "I defy anyone who studies American history 100 years from now to say that affirmative action or abortion were more important than wage stagnation," he said. "In all honesty, wage stagnation is a hard thing to grasp and blame someone for."

Wage stagnation, actually a 20-year-old phenomenon, means that the wage of the typical, or median, American worker has basically stayed unchanged, once a discount is made for inflation. That has been the case whatever the measure: individual hourly wages, weekly wages, or family income, according to Labor Department data.

When prices go up as fast as wages, Americans are left without the wherewithal to improve their living standards, dashing the traditional American dream. Only upper-income people, those who earn more than $80,000 a year, have kept ahead of inflation, while at the other end of the income spectrum, below $30,000, the typical worker's wage has lost ground.



Source: Datastream

The New York Times

Although the problem has been plaguing Americans for years, it is just now rising to the level of a major campaign issue, in the absence of other compelling economic problems, like those that existed in 1992, when Mr. Clinton challenged George Bush for the Presidency.

A recession had just ended. The unemployment rate was much higher than it is today, and during the Bush years the work force had failed to grow. Promising to revive the economy and to create millions of jobs, Mr. Clinton hammered away at his opponent for failing on these counts. And he won.

Nearly three years into the Clinton Administration, these issues seem neutralized. The work force has grown by more than 7 million jobs, as Mr. Clinton often reminds the electorate. Economic growth, while not sufficiently robust for Mr. Clinton to claim boom times, is not so weak that the Republicans can easily accuse the President of hard times.

> **Both Republicans and Democrats think they see a chance for political gain.**

"Absent a recession, which is possible, the economy will tend to create a close election," said Ray Fair, a Yale economist who studies voter reactions to economic issues.

But the economic revival has failed to revive wages. Quite the contrary, four years into the recovery, the wage problem has worsened in some ways.

This year, not only wages but total compensation, including benefits, are failing to keep up with inflation. Before, when companies added up what they paid in wages and benefits, like health care and pensions, the total has usually exceeded the inflation rate. The lag in total compensation is the first since the last recession.

"Middle-class squeeze may be a better descriptive phrase for what is happening than wage stagnation," said William Kristol, a former adviser to Republican candidates and now editor of The Standard, a conservative magazine. He said the 1996 campaign might offer an opportunity to address the problem. "If the economy stays in reasonable shape," he said, "you could get a substantive debate over the competing solutions to wage stagnation and the social problems that go with it."

That would not be an easy debate. Wage stagnation hovers in the background of the budget furor, but voters need skills in economics to connect the two and make a judgment.

The Clinton Administration argues, for example, that wages will continue to stagnate if the Republicans succeed in trying to balance the budget by eliminating such items as federally financed job training, tax incentives for education, Head Start programs and subsidized student loans. All of these programs lead to a more skilled work force, the Administration argues, and eventually higher wages.

The Republicans insist that a balanced budget in itself will push up wages over time. A balanced budget means less borrowing by the Government from the pool of national savings. Less Government borrowing frees up money for companies to borrow, at lower interest rates. And these borrowings, invested properly, generate jobs in an expanding economy and ever-higher pay.

No one knows which approach is right or whether the problem requires some other tonic — much stronger economic growth, for example, or more powerful unions, or a lower capital gains tax. Professional economists can be found advocating each viewpoint.

"Unfortunately or fortunately, people do not vote on economic theories, but on results, and they are not getting them," said Richard A. Gephardt, the House minority leader, who is working with White House strategists to make wage stagnation a big campaign issue. "They sought results in 1992 and 1994 and they are going to keep looking."

The frustration could bring non-economic issues to the fore. Senator Bob Dole's strategists think so, and he is the front-runner for the Republican Presidential nomination.

"The 1996 election will be a referendum on President Clinton's Presidency," said William Lacey, who is Mr. Dole's deputy campaign chairman. "And in that referendum, Dole will be seen as superior in terms of Presidential leadership and character."

President Clinton, on the other hand, plugs away at making wage stagnation a main issue. Endorsing federally sponsored affirmative-action programs in a speech last month, he argued that rising resentment against minorities is really resentment that incomes have stagnated.

What would be more appropriate, he said, "would be an honest debate about how we all got into the fix we are in, and what we are all going to do together to get out of it."

First to College, and Then to the Mill

Continued From First Business Page

percent last year. Similar, more modest gains have occurred among skilled production and craft workers.

Consider the **Allegheny Ludlum** Corporation, a specialty-steel producer based in Pittsburgh. "Of the last 152 people we have hired for blue-collar jobs, 80 percent had more than a high school diploma," said Robert P. Bozzone, vice chairman. "Of that, 15 have college degrees and 86 have two-year degrees. I'm sort of flabbergasted. Twenty years ago we had to battle to get high school equivalents."

Well-educated workers are turning up on assembly lines as well as in steel mills. At the **Ford Motor** Company, virtually all the plant-floor workers hired in recent years have high school diplomas or more, and the percentage of college graduates has risen sharply, from 1.2 percent in the mid-1980's to 4.7 percent in the last two years.

Money is clearly a lure. Mr. Bozzone reported that the average plant-floor worker at Allegheny Ludlum made $42,000 last year, and auto workers' pay is in that range as well. At Gallatin, bonuses for education, production and company profits can lift an engineer's pay above $50,000 in a good year, company officials said.

Young engineers see automated factories as a form of graduate school.

Not that recent graduates foresee whole careers on the plant floor. Many young engineers at Gallatin Steel say they see the mill as a form of graduate school, one that will lift them up the career ladder faster than all those recent graduates stuck in often-boring management trainee programs.

"I'm getting exposure to the management of new technology, and that has got to help anywhere I go," said Mr. Weigel, who is 26. "I'm stationed in the control pulpit, but I'm constantly going out to get a feel for what's happening on the floor."

And Matthew McKnight, a 32-year-old coiler operator at Gallatin with a degree in industrial management, also has other aspirations. For now, however, he is busy figuring out better ways to operate the warehouse and enjoys the fact that his job is close to home.

As economic opportunities have been shrinking, technical requirements in manufacturing have been increasing. "Manufacturers are taking as much touch labor out of the process as they possibly can, so the systems will become more complex and demanding," said Douglas E. Olesen, president of the Battelle Memorial Institute, a private research company in Columbus, Ohio.

That's just part of the equation. "Companies are faced with the increasingly rapid obsolescence of products, so they have to develop new products faster," Mr. Olesen said. "You need manufacturing people who can be part of new-product development teams as well."

Speaking more broadly, Robert B. Reich, the Labor Secretary, said in an interview that computerization had transformed manufacturing. "We are seeing the emergence of the white-collar factory," he said.

He said the notion of large numbers of people tending machines in manufacturing plants was outmoded. "Robots and computers are doing most of the monitoring now, and there are very few people standing around," he said. "The people in the factory are often involved in engineering design and customer application engineering."

At Gallatin, Kristen Anderson, 29, is putting her metallurgical education to work overseeing the use of fire-resistant bricks that line the mill's furnace and other equipment handling liquid steel. "My job is to hold down the cost of bricks by using the right type of bricks for the job," she said. "If we are going through bricks too fast, I've got to find a solution."

Ms. Anderson, who graduated from the Colorado School of Mines, is convinced that her experience, first as a furnace operator and now as a materials manager, will help her land other jobs later. "Companies are more likely to hire someone who has hands-on experience," she said.

Mr. Kosanovich, Gallatin's president, argues that he is helping the young engineers by giving them operating experience while their education is still clear in their minds. "I am convinced that people just out of college are among the worst-utilized human assets," he said. "They go into trainee programs, and by the time they get into the work force, their skills have atrophied."

By operating sophisticated equipment that can turn a pile of scrap into a coil of steel in just a few hours, they are being immersed in the practical application of concepts they learned in college, Mr. Kosanovich said. "We want them to work on the stuff they studied," he said.

Of course, making steel is still hot, hard, sometimes dangerous work in a plant that usually operates round the clock, seven days a week. But Gallatin officials said they did not try to disguise this reality. "There were a few people who did not hear what we were saying," said Brett Guge, the human resources director. They did not last long.

In the plant, it is impossible to distinguish the engineers from other workers. All wear light blue shirts, dark blue pants and orange safety helmets. When something breaks or has to be adjusted, the engineers get their hands just as dirty as other workers.

The company has blurred social distinctions in an effort to head off any tension between those workers who have college degrees and those who do not. Paul Stevens, who joined Gallatin after 21 years of tending ships' boilers in the Navy, compared the recent graduates to young ensigns. "My attitude is that they have something to offer, but that I have something to offer as well," he said. "I'm a reality check to their theory."

Other companies seem to be following the pattern of staffing their new mills with small numbers of well-trained young people who are expected to operate without much supervision. **Ipsco** Inc., which is building a steel mill near Davenport, Iowa, hired 27 college graduates as its first employee group and sent them to a plant in Canada for training.

Trico, a joint venture of LTV Steel, **British Steel** and **Sumitomo Metal Industries**, is also seeking well-educated workers for an advanced mini-mill that it is building near Decatur, Ala. Kenneth L. Pohl, Trico's vice president for human resources, does not have a specific target for the educational level of the work force, but he knows what he is looking for.

"We want folks who already know a lot and have demonstrated the ability to learn," he said. "We will teach them what they need to know, pay them a lot and expect a lot from them."

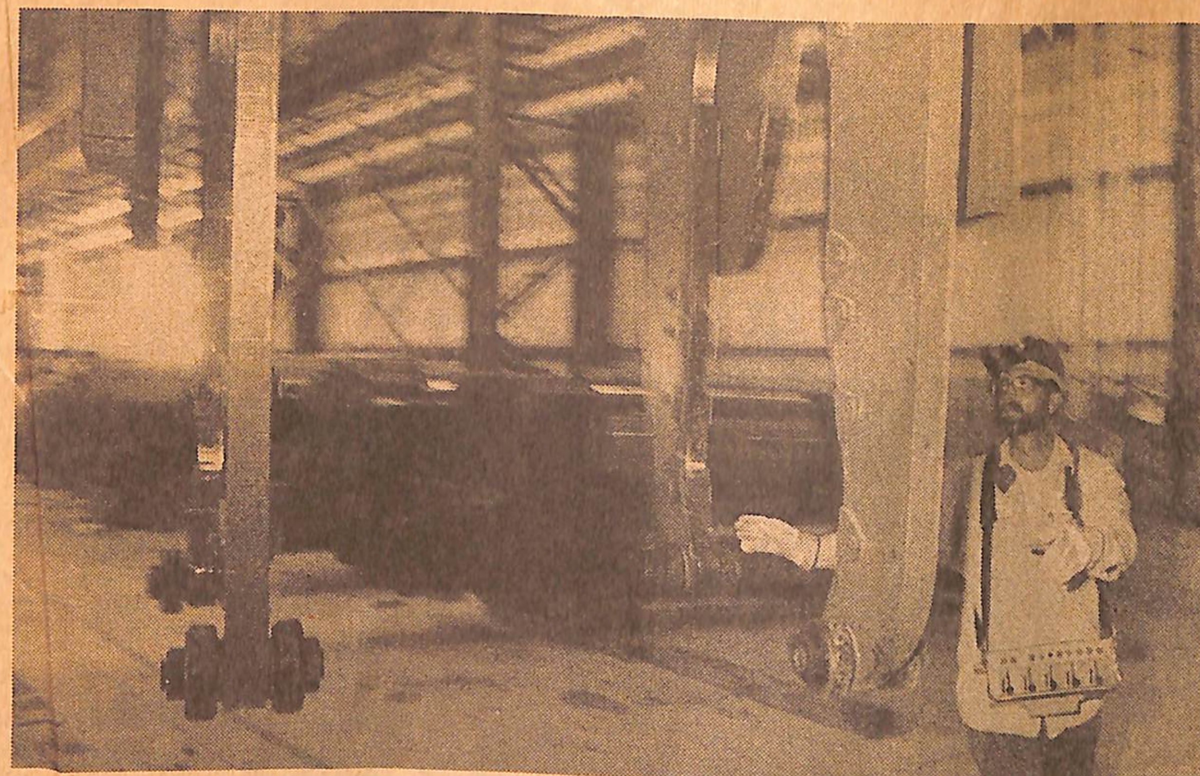
Engineering educators see first jobs in places like steel mills as good experience for recent graduates. "That's a very intelligent thing to do, and that is the way the Japanese system works," said Harold J. Raveche, the president of the Stevens Institute of Technology in Hoboken, N.J. "It represents a chance to put manufacturing higher on the ladder in the eyes of the engineering graduate."

John E. Hopcroft, dean of the college of engineering at Cornell University, said, "It is a good idea for people to understand how business works and it could accelerate their careers compared with sitting behind a desk somewhere."

Mr. Pohl of Trico said he had doubts that graduate engineers would be content to do shift work in a mill for more than a short time. "They may conclude before long that this is not the best use of their education," he said. "I'm not sure how good we would be at keeping them."

Mr. Kosanovich said he anticipated that most of the engineers in the Gallatin plant would move on. "Will people get tired and leave?" he said. "Yes. We expect turnover, but we should be able to replenish our ranks from the same sources on an ongoing basis."

He acknowledged that a rapidly changing work force was more expensive, primarily because of the costs of training new workers. "We think the rewards will be greater than the potential costs," he said. "But I'll admit it's still a theory. We have not proven it yet."



J. Breck Smither for The New York Times

Paul Stevens, who spent 21 years tending ships' boilers in the Navy, now works at the Gallatin Steel plant in Ghent, Ky. "I'm a reality check to their theory," he said of the recent college graduates with jobs at the mill.

From Ivy Halls to Factory Floors

People with college experience are increasingly filling a variety of production jobs. Today, manufacturing demands more sophisticated skills even as some graduates are finding that blue-collar work can pay better than other entry-level jobs.

FACTORY WORKERS

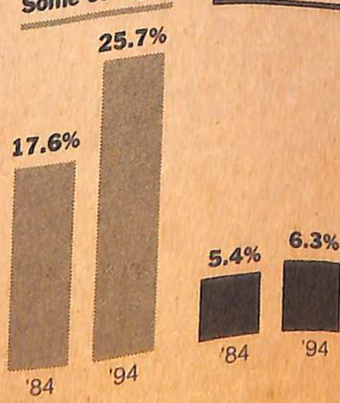
Operators, fabricators and laborers.

'84 WORK FORCE: **16.4 million**
'94 WORK FORCE: **10.6 million**

SPECIALIZED WORKERS

Precision production and craft workers.

'84 WORK FORCE: **12.4 million**
'94 WORK FORCE: **12.8 million**



Source: Bureau of Labor Statistics

Introduction by Nintendo

REDMOND, Wash., Aug. 21 (Reuters) — Nintendo of America introduced Virtual Boy today, a 32-bit home video-game system that it says includes three-dimensional effects. "Virtual Boy will take video-game players to a completely new dimension in gaming," Peter Main, Nintendo's executive vice president of marketing, said, adding that the American unit of the Nintendo Company of Japan expects to sell more than 1.5 million hardware units and 2.5 million pieces of software by the end of the year. The new game will have a retail price of $179.95.

Business Day

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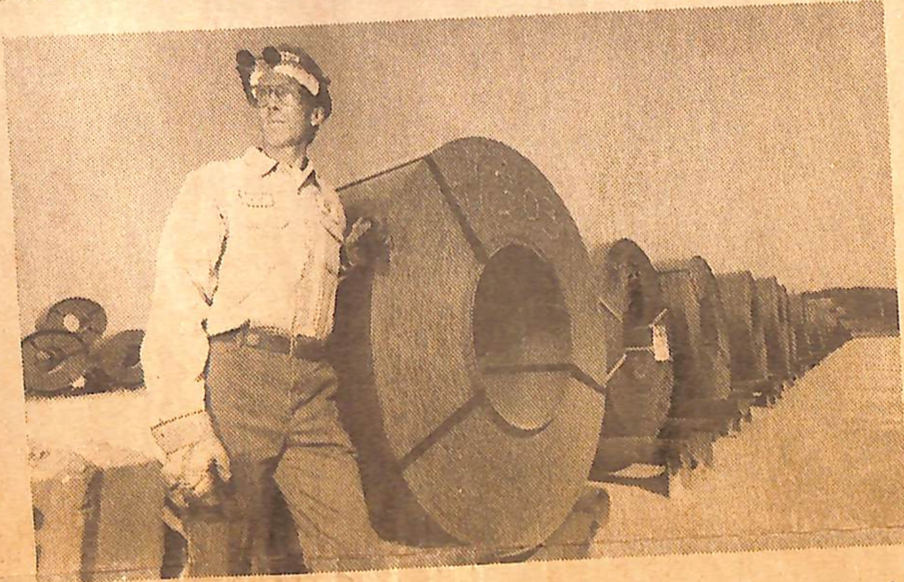
...Y, AUGUST 22, 1995

The New York Times

First to College, Then the Mill

More Graduates Are Drawn to Blue-Collar Work

Photographs by J. Breck Smither for The New York Times



In its recently built mill in Ghent, Ky., Gallatin Steel employs highly educated workers to run computerized systems that produce coils of sheet steel. Here are three of those workers:

ABOVE Kristen Anderson, 29, a graduate of the Colorado School of Mines, expects her experience as a materials manager to help her get other jobs.

RIGHT Matthew McKnight, 32, is a coiler operator with a degree in industrial management from Eastern Kentucky University.

BELOW William Weigel, 26, who has a master's degree in mechanical engineering from the University of Louisville, operates a machine that casts liquid steel into solid slabs.

By JOHN HOLUSHA

GHENT, Ky. — After five years of study, William Weigel earned a master's degree in mechanical engineering from the University of Louisville in May. A few weeks later, he started work at a steel mill, running a machine that casts liquid steel into solid slabs.

Despite steel's image as an industry where strong backs are more useful than strong brains, Mr. Weigel has plenty of high-technology company. About 40 percent of the roughly 200 factory workers at the Gallatin Steel Company here have college degrees, mostly in mechanical engineering or metallurgy, and an additional 20 percent have two-year degrees.

It is just such highly educated workers, company officials say, who are needed to operate the computerized systems at this recently built mill. "This plant is the Starship Enterprise of the steel industry," said Milan Kosanovich, the president of Gallatin, which is a venture of the Canadian steelmakers **Dofasco** Inc. and **Co-Steel** Inc. "With 200 people we will produce as much steel as it used to take 5,000 people to make."

The mill, on an old tobacco farm near the south bank of the Ohio River, may be an extreme case, but it is clearly a sign of the times: As manufacturing has become more automated, workers' skills have had to increase. And the streamlining of corporate America has cut the number of entry-level office positions, making a good factory job look a lot better.

"In this economy, $19-an-hour jobs with good benefits are a lot more desirable than a few years ago" for college-educated workers, said Harley Shaiken, a professor with the Institute of Industrial Relations at the University of California at Berkeley.

Today, many more people with education beyond high school are working on factory floors. Government figures showed that almost 5 percent of production workers last year were college graduates while another 16 percent had some college education. Those figures compare with just 2.8 percent and 11.2 percent, respectively, a decade earlier.

And the whole educational level of the factory work force has been upgraded. In 1984, only 40 percent of all production workers had graduated from high school, compared with more than 71

Continued on Page D7

Flat Wages Seen as Issue In '96 Vote

Only the Wealthy Can Claim Gains

By LOUIS UCHITELLE

Wage stagnation, which has persistently held down the living standards of tens of millions of Americans, is finally emerging as a big economic issue for both Democrats and Republicans as the 1996 election campaign gets under way.

The Clinton Administration, in particular, is pushing the issue, convinced that by emphatically recognizing the problem, the Democrats can win back votes lost to Republicans in last November's Congressional election. And both parties recognize that wage stagnation is at the heart of the debate over the budget.

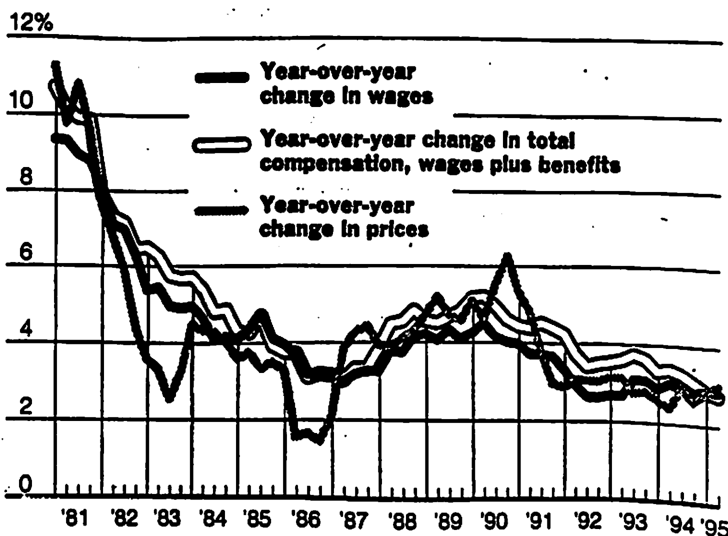
"You need to make wages a major campaign issue," said Laura D'Andrea Tyson, chief of the President's National Economic Council. She noted that President Clinton frequently refers to wages in his speeches and public remarks. He argues that he has presided over the revival of the economy and the creation of millions of new jobs, and that the task now is to create a strategy to make wages grow again.

"If the Republicans are speaking of this problem, we identified it for them," Ms. Tyson said.

The Republicans are certainly speaking of the problem, and a common response is emerging from party leaders: that Mr. Clinton lacks a solution to the problem. "If he is suggesting that he is politically impotent on this huge issue," said Tony Blankley, a spokesman for Representative Newt Gingrich, the House Speaker, "then he is opening himself up to the argument that he should hand over the Presidency to someone who isn't impotent."

The problem with wage stagnation as a campaign issue is that there is no ready solution. And campaign issues without ready solutions do not easily sway voters, says James Carville, President Clinton's chief strategist in the 1992 election, who coined the slogan, "It's the economy, stupid."

It's not that Mr. Carville fails to recognize the importance of wage stagnation. "I defy anyone who studies American history 100 years from now to say that affirmative action or



The New York Times

the income spectrum, below $30,000, the typical worker's wage has lost ground.

Although the problem has been plaguing Americans for years, it is just now rising to the level of a major campaign issue, in the absence of other compelling economic problems, like those that existed in 1992, when Mr. Clinton challenged George Bush for the Presidency.

A recession had just ended. The unemployment rate was much higher than it is today, and during the Bush years the work force had failed to grow. Promising to revive the economy and to create millions of jobs, Mr. Clinton hammered away at his opponent for failing on these counts. And he won.

Nearly three years into the Clinton Administration, these issues seem neutralized. The work force has grown by more than 7 million jobs,

Both Republicans and Democrats think they see a chance for political gain.

as Mr. Clinton often reminds the electorate. Economic growth, while not sufficiently robust for Mr. Clinton to claim boom times, is not so weak that the Republicans can easily accuse the President of hard times.

said William Kristol, a former adviser to Republican candidates and now editor of The Standard, a conservative magazine. He said the 1996 campaign might offer an opportunity to address the problem. "If the economy stays in reasonable shape," he said, "you could get a substantive debate over the competing solutions to wage stagnation and the social problems that go with it."

That would not be an easy debate. Wage stagnation hovers in the background of the budget furor, but voters need skills in economics to connect the two and make a judgment.

The Clinton Administration argues, for example, that wages will continue to stagnate if the Republicans succeed in trying to balance the budget by eliminating such items as federally financed job training, tax incentives for education, Head Start programs and subsidized student loans. All of these programs lead to a more skilled work force, the Administration argues, and eventually higher wages.

The Republicans insist that a balanced budget in itself will push up wages over time. A balanced budget means less borrowing by the Government from the pool of national savings. Less Government borrowing frees up money for companies to borrow, at lower interest rates. And these borrowings, invested properly, generate jobs in an expanding economy and ever-higher pay.

No one knows which approach is right or whether the problem requires some other tonic — much stronger economic growth, for example, or more powerful unions, or

abortion were more important than wage stagnation," he said. "In all honesty, wage stagnation is a hard thing to grasp and blame someone for."

Wage stagnation, actually a 20-year-old phenomenon, means that the wage of the typical, or median, American worker has basically stayed unchanged, once a discount is made for inflation. That has been the case whatever the measure: individual hourly wages, weekly wages, or family income, according to Labor Department data.

When prices go up as fast as wages, Americans are left without the wherewithal to improve their living standards, dashing the traditional American dream. Only upper-income people, those who earn more than $80,000 a year, have kept ahead of inflation, while at the other end of

times.

"Absent a recession, which is possible, the economy will tend to create a close election," said Ray Fair, a Yale economist who studies voter reactions to economic issues.

But the economic revival has failed to revive wages. Quite the contrary, four years into the recovery, the wage problem has worsened in some ways.

This year, not only wages but total compensation, including benefits, are failing to keep up with inflation. Before, when companies added up what they paid in wages and benefits, like health care and pensions, the total has usually exceeded the inflation rate. The lag in total compensation is the first since the last recession.

"Middle-class squeeze may be a better descriptive phrase for what is happening than wage stagnation,"

ample, of more powerful unions, or a lower capital gains tax. Professional economists can be found advocating each viewpoint.

"Unfortunately or fortunately, people do not vote on economic theories, but on results, and they are not getting them," said Richard A. Gephardt, the House minority leader, who is working with White House strategists to make wage stagnation a big campaign issue. "They sought results in 1992 and 1994 and they are going to keep looking."

The frustration could bring non-economic issues to the fore. Senator Bob Dole's strategists think so, and he is the front-runner for the Republican Presidential nomination.

"The 1996 election will be a referendum on President Clinton's Presidency," said William Lacey, who is Mr. Dole's deputy campaign chairman. "And in that referendum, Dole will be seen as superior in terms of Presidential leadership and character."

President Clinton, on the other hand, plugs away at making wage stagnation a main issue. Endorsing federally sponsored affirmative-action programs in a speech last month, he argued that rising resentment against minorities is really resentment that incomes have stagnated.

What would be more appropriate, he said, "would be an honest debate about how we all got into the fix we are in, and what we are all going to do together to get out of it."

Buy hard: with a vengeance

Over the past year the dollar has plunged, and then bounced back. Is there such a thing as long-term equilibrium in currency markets?

ECONOMICS FOCUS

SUPPOSE a man climbs five feet up a sea wall, then climbs down 12 feet. Whether he drowns or not depends upon how high above sea-level he was when he started. The same problem arises in deciding whether currencies are under- or over-valued. The dollar has gained almost 20% against the yen and 10% against the D-mark from its low point in April. Some pundits are already fretting about the impact of a "strong" dollar on the American economy. Yet the currency is still around 60% below its level in 1985. To predict whether the dollar has further to rise, it would help to have some idea about its "correct" value.

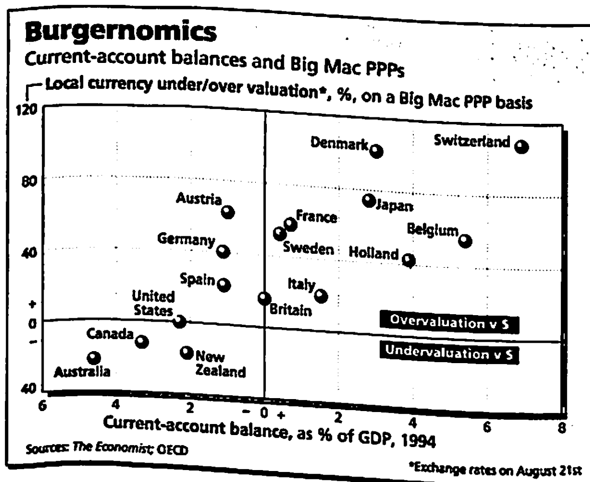
Economists like to talk about currency misalignments, and exchange rates being under- or over-valued. But this presumes that they know what a currency's long-term equilibrium rate is. The truth is that there is wide disagreement about how to define an equilibrium, let alone how to measure it.

The oldest method of defining long-term exchange-rate equilibrium is purchasing-power parity (PPP). This is based on the notion that goods and services should cost the same in different countries when measured in a common currency. According to this theory, the exchange rate between two currencies should, in the long run, move towards its PPP—ie, the exchange rate that equalises the prices of an identical basket of goods and services in the two countries.

A popular version of PPP is *The Economist's* Big Mac index. Once a year we calculate PPPs by comparing the prices of a McDonald's Big Mac burger in different countries. This, along with more sophisticated estimates of PPP, signals that the dollar is still hugely under-valued against the other main currencies. For instance, the Big Mac index suggests a dollar PPP of ¥169 and DM2.07, compared with exchange rates on August 22nd of ¥97 and DM1.49. The OECD estimates the dollar's PPP at ¥181 and DM2.11. On this basis, therefore, the greenback has a lot further to climb.

But in practice PPPs have proved a poor guide to exchange-rate forecasting. Currencies can deviate from their PPP for long periods. The dollar, for example, has been under-valued relative to its PPP for most of the past 15 years. One snag is that this method ignores capital flows. That was fine when trade flows dominated foreign-currency transactions, but the value of foreign-exchange trading is now 70 times bigger than that of world trade. Today, capital flows largely determine the size of current-account balances, rather than the other way round.

The PPP is only a sustainable equilibrium exchange rate if the current account is simultaneously in balance. If, however, a country has a persistent current-account deficit, its foreign debt will rise. As a result, it will need to run a trade surplus to cover its growing debt interest payments. This will require the exchange rate to remain below its PPP.



The chart, based on an analysis by Merrill Lynch, an American securities firm, shows that there is a strong correlation between a currency's under- or over-valuation against the dollar relative to its Big Mac PPP and that country's current-account balance. Countries with big current-account deficits have the most under-valued currencies. The exchange rates of countries with big surpluses tend to be at a premium to their PPP. This suggests that if a country has a persistent current-account deficit, its exchange rate could remain belov its PPP almost indefinitely.

FEER of the unknown

An alternative notion of exchange-rate equilibrium tries to take account of capital flows. The so-called fundamental equilibrium exchange rate (FEER) is the rate that will generate a current-account deficit or surplus equal to the sustainable inflow or outflow of capital.

Unlike PPPs, which remain constant in real terms, FEERs will change over time in line with changes in net foreign assets or liabilities. Once an exchange rate departs from its FEER, this will affect the size of the current-account balance, the level of foreign debt, and hence the FEER itself.

John Williamson, an economist at the Institute for International Economics in Washington, DC, who pioneered the concept in the early 1980s, calculates current FEERs for the dollar at ¥105 and DM1.60. In contrast to the message from PPPs, this suggests that the dollar is already quite close to its equilibrium.

But FEERs are also flawed. Their value is sensitive to the estimated level of sustainable capital inflows. And in a world of highly mobile capital this whole concept may not make sense, since investors' asset preferences can easily shift, and will themselves depend upon the value of currencies. Moreover, some economists argue that by itself, a lower dollar will not eliminate America's current-account deficit. It will simply create inflationary pressure in America and deflationary pressure in Japan, offsetting the gain in competitiveness from a cheaper dollar. The only sure cure for America's trade gap is higher domestic savings.

This suggests a third possible yardstick for judging where the dollar may head in the longer term. If America continues to run large current-account deficits, it will flood the world with more dollar-denominated debt. To continue financing these deficits, it must either raise interest rates, or the exchange rate will have to fall by enough to make dollar assets attractive to foreigners. The implication of this is that without changes in America's monetary and fiscal policies (ie, big budget cuts to boost domestic savings), the dollar's medium-term path is likely to be down, regardless of any hypothetical notions of equilibrium.

What lessons should investors draw from all this? Mainly that economists never agree. Depending upon which of the three views on exchange rates you favour, the dollar's future path could be up, down or sideways. Indeed, given the inadequacy of economics when it comes to understanding exchange rates, terms such as "currency misalignment" and "overvaluation" should be used sparingly.

1950s of convicted Japanese war criminals. The BBC—still the voice of the nation, if there is one—had a week-long programme of "VJ 50" screenings. Little reflected the blessed fact that August 1945 ended Britain's six years of battle; much of it—from documentaries through part of a serial set in a Japanese prisoner-of-war camp for women to "The Bridge on the River Kwai"—was devoted to Japanese nastiness.

The climax came in the national celebrations. Was Britain, like other countries around the globe, rejoicing at an end to war, 50 years of peace and a world that has turned old enemies into friends? Essentially, no. The emphasis was on the Japanese war, and on the nation's thanks to those who fought it. Well-deserved thanks, just as the flow of patriotism was well-justified. But where was friendship? Where was the future? Where was the recognition, as there was with Germany, that today's Japan and Japanese are not the same as yesteryear's? The queen—and she does not speak without government advice—recalled last May's commemoration of the end of the war in Europe, when "we met our former enemies in a spirit of reconciliation". Pointedly, she used no such word, did not even hint at it, towards Japan.

The same day saw a bitter service of "thanksgiving for victory over Japan" in St Paul's Cathedral, arranged by those who fought or were interned. The queen's husband, who was a naval officer in 1945, was there. So were some government ministers, and 2,000 other people. At a service of reconciliation in Westminster Abbey, just 300 people turned up, not a minister among them. That was the only event to which Japanese officials were invited.

To honour the past is one thing, to live in it another. Here are two ex-enemies that have to share a future. Is one of them still not ready? It is a sorry way to face the 21st century.

Prosperity, not politics

For the sake of the American economy, Bill Clinton should make up his mind about Alan Greenspan

FUTURE lexicographers may discover the following word:

> Clindecision, sb, mid 1990s [NAmer]. A political decision or appointment, not necessarily the right one, which is put off until, and often beyond, the final moment it can be made, the delaying of which causes damage to the decider, the appointee and the country.

Bill Clinton seldom makes up his mind quickly. This is a man who took more than a year to appoint his own administration. Sometimes that has been damaging, as on Bosnia and trade, other times merely annoying to those who like things done tidily. In monetary policy, however, a period of Clindecision could wreak havoc. Yet that is what will be in prospect if President Clinton does not now move promptly and speedily to appoint Alan Greenspan to a further term as chairman of America's Federal Reserve. Or, which would probably be worse but must still be done quickly, to appoint somebody else. Technically, this choice need not be made until next March. Practically, to leave it that late would be a disaster.

The reason is that financial markets are as sensitive to political dithering as are Bosnian Serbs. Fortunately, this does not normally matter: America's interest rates are set not by the Clinton administration but by the Open Market Committee of the Federal Reserve. After a poor patch in the 1970s, the Fed has clawed back much of its credibility with the markets under the chairmanships of Mr Greenspan and his predecessor, Paul Volcker; the markets in turn have allowed it to keep inflation at bay with lower interest rates and less economic suffering than might have otherwise been the case. This credibility is an asset which it would be foolish to lose.

Yet that could happen. Mr Greenspan's term runs out at the beginning of March—and Mr Clinton must decide whether to reappoint him. That sounds a long way off. But with an election just over a year away and the economy likely to be a central issue, the financial markets have grown suspicious. Mr Greenspan himself was accused of politicking in early July, when the central bank reversed a series of interest-rate hikes with a quarter-percentage-point reduction in the federal funds rate, to 5.75%. Bond yields reacted by failing to fall, thus showing themselves unconvinced that inflation was slowing. True, there were plenty of reasons, other than fears of politicking, to explain this. But there is no sensible reason to encourage such fears in the first place.

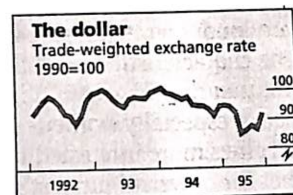
This week the Fed decided not to lower rates again. That was a welcome decision, in economic terms, for economic growth remains strong and inflation remains a worry. Yet in political terms it will have been a tough call. These decisions are hard enough for a central banker when the waiting audience clustered around dealing terminals trusts his inflation-fighting instincts; now Mr Greenspan's motives and Mr Clinton's vacillations are entering the moneymen's calculations. Fed appointments have a history of being delayed: Mr Clinton has already left one governorship vacancy unfilled. It would be unusual (and not just by his own standards) for Mr Clinton to name his choice ahead of schedule. Nevertheless he should do so, quickly.

Keep Greenspan on

Assuming, as seems likely, that Mr Greenspan wants to stay on, should Mr Clinton choose him? The answer depends on the alternatives. But Mr Greenspan has acquitted himself well. He has steered monetary policy skilfully through the 1987 stock-market crash, the banking and thrift crises of the late-1980s, the recession of the early 1990s and the subsequent recovery. If he has sometimes been prone to keep interest rates lower than this newspaper might have wished, it is still hard to think of a Clintonite appointee who would be tougher.

An early decision needs to be made for the sake of the Fed, and the American economy. However, it would also do Mr Clinton no harm. Mr Greenspan might even be more comfortable lowering rates if he knew the markets trusted his motives. Besides, Mr Clinton is keen to convince voters that he cares more about the nation's future than his own. This message would sell better if he were to behave accordingly. It is time for a decision, not more Clindecision.

The dollar's revival



Central-bank intervention can supplement macroeconomic policy. It cannot replace it

AUGUST has been an exciting month in the currency markets. Co-ordinated intervention on August 15th propelled the dollar higher against the yen and the D-mark, reinforcing a rally that had been quietly under way for several weeks (see page 69). Central banks in America, Germany and Japan had followed the first and second rules of intervention: take traders by surprise; and intervene with the grain of the market, not against it, for you may be able to accelerate an existing movement, but you cannot reverse one, at least not for long. That second rule, however, leads on to the third and most vital one. This is that insofar as currency markets take their lead from governments, it is not intervention that they really watch. The things that count are sustained macroeconomic policies.

This simple point needs to be kept in mind by anyone trying to work out whether the dollar's rally is more than merely a holiday romance. The *Wall Street Journal* described the central banks' intervention on August 15th as "a brilliant display of exact timing, flawless execution and solid co-ordination" and quoted an enthusiastic economist at J.P. Morgan, an American bank, as saying that the intervention "showed the major central banks have a coherent strategy in place for sending the dollar higher." This is nonsense. Central banks are not powerful enough to have such a strategy. They hold only one of the macroeconomic tools that matter, monetary policy. But fiscal policy is beyond their reach. This point does not rule out a sustained rally. But intervention alone proves nothing.

The idea of a sustained rally is based on the following hypotheses. In Washington, DC, budget-cutting is in fashion. If cuts are made in the so-called "entitlement" programmes (Medicare, welfare and so on) that have made the federal deficit so hard to control, there would be a chance that the government would make a smaller claim on America's pool of savings. This is a fair bet though far from certain; the odds would shorten if the 1996 election brings a Republican president alongside the already Republican-dominated Congress. This might (though some economists dispute it) boost the dollar.

Meanwhile, Japan has been floundering in a deflationary slump, worsened by a strong yen, made scarier by the failure of a mutual bank two weeks ago, and made politically alarming by America's willingness to start a trade war. A trading truce, followed by the rescue of that bank with public funds, were both encouraging signs. The finance ministry then hyped a tiny relaxation of controls over some capital outflows. But the changes that matter still lie in the future. These would be a serious monetary relaxation, through purchases of public debt by the Bank of Japan to increase liquidity and raise bond prices; and a substantial fiscal reflation. These changes may happen. But they have been mooted before, and not delivered.

Remember Plaza, Louvre and Black October

The only way in which currency-market intervention matters is if it truly indicates a shift in underlying policies. Yet the bank on which most attention was focused on August 15th, the Bundesbank, sits in the country least likely to alter its policies. A weaker D-mark makes Germany's central bank less prone to cut its interest rates because, other things being equal, a weaker currency adds to inflationary pressures. The right places to look remain Japan and the United States.

The last time a big effort was made to shift those countries' exchange rates was in 1985-87, with the Plaza and Louvre accords. Intervention was co-ordinated, and monetary policies too. But there were two problems, which contributed to the stockmarket crash of October 1987. One, that the chosen monetary policies suited the currency markets but not domestic needs, looks unlikely to recur this time. But the other looks all too possible. It was that fiscal policies were not, in fact, co-ordinated. Governments thought currency movements and stirring communiqués would suffice. They were wrong. If Japan does reflate and America does retrench, a sustained shift in exchange rates is possible. If they do not, don't bet on it.

Degrees of poverty

Life has improved in the world's poor countries. But it is still wretched for their poorest citizens—whom rich-world aid ought to reach and does not

THE developing world? Yes, it really is developing, and fast. Overall, the world's poor countries have made as much progress in health and education in a generation as the rich world did in a century. On average, their infant mortality has more than halved since the 1960s, while the rate of school enrolment has risen almost 50%. Though their GNP per person is still only 5% of that in rich countries, their citizens' life expectancy has risen by 17 years to 61, against 76 among the rich.

These figures, from the United Nations' annual Human Development Report (see page 35), are good—but not good enough. Averages, as so often, hide striking differences. Some countries have made huge improvements: in Costa Rica and Sri Lanka, for instance, the proportion of children dying in infancy has gone down by more than 70% since 1970. Others have barely progressed: only four out of ten Pakistani children go to primary school, a rate unchanged in a generation. What can be done to prompt the laggards?

Solid economic growth will help. But it is not enough. Nor, more surprisingly, is it a prerequisite. Better health and education, a better life overall for the poorest, do not have to wait

until the whole nation gets richer. As the UN points out, some very poor countries have done well in health and education. The characteristic they share is governments, national and local, that direct their (modest) spending to make sure that the poor—especially women—have access to public services. Political elites more interested in big armies, big projects, big subsidies for powerful interest groups and big Swiss bank accounts for themselves are the worst enemies of the poor.

The rich could try harder too

What about the contribution of the rich world? For the past generation many billions have been spent on foreign aid, often in the name of the poor, but without reaching them.

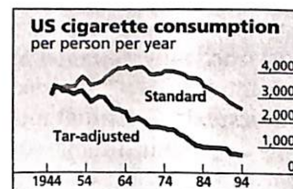
Multilateral agencies such as the World Bank and regional development banks are indeed putting more emphasis on basic services like clean water, primary schools or baby clinics. The World Bank has lent $3.3 billion for health, education and nutrition in the past five years, compared with $900m in the previous decade. The Asian Development Bank over those five years has quadrupled the share of its lending that goes to basic education. But such bodies are not the main suppliers of foreign public-sector capital. And those who are—individual governments—have not advanced in the same way.

Today, as in the past, country-to-country aid often ends up in the pockets of the "donor" country's businesses. Much aid money—more than a third of disbursements made by France and Germany, to take two notable examples—is tied: the money must be spent on goods or services from the donor country. Even untied aid may well go the same way, buying consultants, conferences and general bureaucracy.

Even the aid money spent in the recipient country often does not assist those who most need it. Unicef, the UN agency for children, reckons that in 1990 more than 80% of bilateral aid to education went to secondary and higher education, though primary schooling matters more. Much the same is true of health. Relatively low-cost efforts at immunisation, hygiene and maternity care help vast numbers of people—children especially—outlive the diseases and other ills that have disappeared in the West. Yet, says Oxfam, a non-governmental British agency, primary health care gets about 1% of international aid flows. Donors are more tempted to see the concrete results of their money in the form of well-equipped hospitals in the capital city. For the recipient government, building fancy universities or hospitals is all too often a dandy opportunity for graft. With these incentives, it is hardly surprising that the "20-20 compact"—a proposal made at the UN's summit on poverty in Copenhagen under which donors would ensure that 20% of aid went to basic services if recipients promised at least 20% of government spending did so as well—never got very far.

Foreign aid will never be the crucial factor in improving either health or education in poor countries. In education, for instance, it accounts for less than 5% of what these countries collectively spend of their own money. But, directed properly and used in well-governed countries—often not by the government concerned—it can make a real difference. That is not true of money whose main result, and often aim, is to subsidise bad governments or donor-country industries. Few rich countries will ever produce aid out of pure altruism (and the bigger they are the less likely that is). But if they are truly trying to help, they should remember who needs help the most.

An anti-smoking wheeze



Washington needs a sensible all-drugs policy, not a "war" on teenage smoking

HERE at *The Economist*, people who want to light a cigarette do so where they will not bother others. That is as it should be: smoking is smelly and, to the sensitive, annoying. But that is as far as this liberal (in the British sense) newspaper goes. In America a century ago, Mary Walker, a decorated Civil War nurse who raged against "evil nicotine", went about the streets using her furled umbrella to bat cigarettes from the lips of unsuspecting smokers. Last week's announcement by the Clinton administration that it would mount a heavy-handed campaign against smoking by teenagers is, alas, more in her tradition than in ours.

The Clintonites have decided to regulate nicotine as an addictive and harmful drug (which it is). Beginning from that premise, they would, among other things, require cigarette advertisements on billboards and in most magazines to be in youth-unfriendly black and white, with no pictures; ban cigarette brands from sponsoring entertainment or sporting events; and require tobacco companies to spend $150m a year on anti-smoking campaigns aimed at teenagers. For present purposes, leave aside, as many European countries have done, the conflicts these measures create with freedom of speech. That apart, does this new "war" on teenage smoking make practical sense?

It is certainly true that smoking is hazardous to the health. So is eating lots of fat, or riding motorcycles (which are 16 times deadlier than cars). A liberal society normally lets people take foolish risks, provided the risk-takers pay the costs and assume them knowingly. In the case of smoking, they do. Kip Viscusi, an economist at America's Duke University, recently had the most comprehensive look to date at who pays for America's tobacco habit. He concludes, as others have done, that smokers pay their own way. What they cost in medical bills, fires and so on, they more than repay in pensions they do not live to collect and nursing-home care they never use. Tobacco taxes in America are now more than high enough to cover any residual costs of second-hand smoke. Far from harming society, American smokers hurt only themselves.

Dangerous choices

But surely the case is different with teenagers? Apparently not. Most people—smokers and non-smokers—overestimate the dangers of smoking by a factor of two or more. Teenagers, it turns out, have an even more exaggerated view of smoking's perils than grown-ups do. Even among American eight-year-olds, 97% know that smoking causes cancer and shortens life, and the vast majority know it is hard to stop. If teenagers

The rise and rise of VAT

Governments are relying more on general consumption taxes, particularly value-added tax, to raise revenue. Why?

ECONOMICS FOCUS

WINSTON CHURCHILL famously remarked that "there is no such thing as a good tax." Faced with a two percentage-point rise in the standard rate of value-added tax (VAT)—from 18.6% to 20.6%—earlier this month, many of the French will doubtless agree with him. France is, after all, already one of Europe's most heavily taxed countries. But leaving aside the question of whether more taxes (rather than bigger spending cuts) is the best way to cut France's budget deficit, the decision to get most of the new revenue from VAT makes sense.

VAT is paid throughout the production process—from the factory all the way through to the shop, with each intermediary (except the consumer) being able to claim back the tax paid. Its cousin, the retail-sales tax, which is used at the state level in America, is levied only at the time of sale to the consumer. Both are consumption taxes, levied when people spend money rather than when they earn it—as income taxes are.

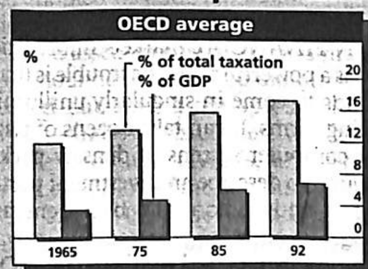
Consumption taxes are usually hailed as an efficient means of taxation. A consumption tax is less likely to distort economic behaviour than income taxes. With high marginal rates of income tax, individuals may have less incentive to work hard. With a consumption tax, their extra income is not taxed until it is spent. Consumption taxes can also be levied on a wide base. In theory, people should be taxed on everything they buy; in practice, things are a little more complicated. Many countries have numerous exemptions from VAT; others tax some goods at lower rates. The wider the tax base, the lower the tax rate needed to raise a given amount of revenue.

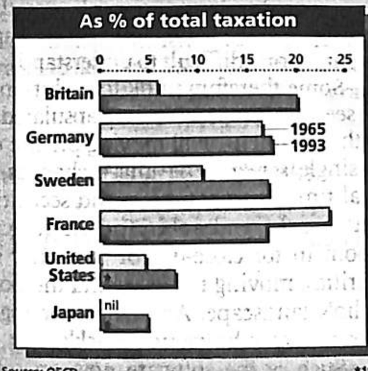
The main argument against consumption taxes is a political one. Personal allowances and higher rates for higher incomes mean that income taxes are progressive: the marginal rate of taxation (the rate people pay on the last dollar they earn) is always higher than the average rate. Consumption taxes, in contrast, are generally levied at a constant rate. This means that poor people, who consume a higher share of their current income than rich people, suffer—so consumption taxes are "unfair". This is true, though many economists argue that the most efficient response of a government should be to give poorer people benefits in cash rather than to distort the tax system.

Over the past 30 years, industrial countries have gradually shifted towards general consumption taxes. According to a new report by the Organisation for Economic Co-operation and Development (OECD) on consumption taxes, rich countries raised an average of only 3.5% of GDP from general consumption taxes in 1965. Three decades later the amount has doubled, to 7.0% (see chart).

Although countries still raise substantial amounts of money from some specific consumption taxes (especially on harmful goods such as alcohol or tobacco), part of this increase is due to a shift from specific taxes (such as excise taxes and import duties) to general ones such as VAT. The average amount of money raised from specific consumption taxes in OECD countries has fallen from 6% of GDP in 1965 to around 4% today. Half the increases in total tax revenue since 1965 has come from general consumption taxes, which now make up nearly a fifth of tax revenue in industrial countries.

General consumption taxes





Source: OECD *1992

VAT has become especially popular. In the 1960s only nine countries in the world levied VAT; now more than 90 do. Of the OECD countries, only America and Australia do not use value-added taxes. In the developing world, too, VAT has become the consumption tax of choice. All Latin American countries now have VAT, as do the ex-communist economies of Eastern Europe.

In principle there is little economic difference between VAT and the American system of retail-sales taxes. Levied at the same rates, and covering the same number of goods and services (ideally all), both taxes should raise the same amount of money. However the different ways in which they are collected makes VAT more efficient. Under a retail-sales tax system, producers, wholesalers and retailers do not pay tax when they buy or sell from one another. VAT, in contrast, is paid throughout the production chain; registered intermediaries (but not the final consumer) reclaim VAT by presenting a set of invoices to the tax authorities.

This makes VAT much harder to avoid. While a good is being produced, sellers have an interest in proving they have paid the tax on their inputs in order to reduce the tax liability on their sales. With a retail-sales tax system, in contrast, the burden of collecting the tax lies entirely with the final seller of the good. If he fails to charge it, the tax on the whole value-added is lost. As the tax rises, the incentive to avoid it increases.

By limiting such incentives, governments can set VAT at higher rates than they could retail-sales taxes. It is no coincidence that sales taxes in America are, on average, below 8%, compared with a total OECD average for general consumption taxes of nearer 20%. Most economists reckon that 10% is the highest level at which a sales tax can be set without large-scale attempts at evasion. So, for countries which have high revenue requirements, VAT makes more sense.

Nonetheless, VAT rates are generally higher than they need be. Some services, such as financial services or insurance, are exempted by almost all countries, largely because it is difficult to work out exactly what the tax should be levied on. But usually the list of exemptions, or goods subject to lower rates, goes much further. In France many foods, medicine and books are taxed at the lower rate of 5.5%. Newspapers are taxed at only 2.1%.

Widening a VAT base is not popular—as Kenneth Clarke, Britain's chancellor found out when he tried to introduce VAT on fuel. On the other hand, any Frenchman who groans at the breakfast table at the thought of a 20.6% VAT rate should consider carefully the croissant on his plate and the newspaper in his hands.

WAVE OF MERGERS IS TRANSFORMING AMERICAN BANKING

FASTER PACE IS EXPECTED

As Old Business Ways Fade, Many Smaller Institutions Decide It's Time to Sell

By SAUL HANSELL

Long pillars of their communities, the nation's banks are merging with each other, moving their headquarters across the country and leaving in their wake disruption, layoffs and potentially higher prices.

The consolidation is now at cruising speed — with 5 mergers among the top 50 banks this year — and the pace is expected to accelerate. And while industry executives say the mergers are creating stronger institutions, big enough to offer innovative services, the practical effect in the short term will be to confront bank customers and employees with corporate name changes, branch closings and job losses.

Indeed, between the rising incidence of mergers and the increasing use of technology, a study by Deloitte & Touche predicted that over the next 10 years half of the nation's 59,000 bank branches will close and 450,000 of the 2.8 million jobs in the banking industry will disappear.

What is more, the deals in the current wave often combine banks in different states and even different regions. That means a bank headquarters, with the employment and community support that it entails, is uprooted.

Unlike the media magnates buying television networks and movie studios in hopes of profiting from the exploding entertainment industry, bankers are merging to survive in a business that is rapidly losing its share to rivals like the Fidelity family of mutual funds and the AT&T Corporation's credit cards.

The banking companies making acquisitions hope to increase profits by eliminating competitors and cutting costs. The sellers want to cash out while they can.

In Boise, Idaho, the banking business could not have looked better to Daniel R. Nelson, chairman of the West One Bancorp. Profits were up, loan losses down and new business brisk.

So why, in May, did Mr. Nelson decide to sell the bank to U.S. Bancorp of Portland, Ore., for $1.57 billion?

"Timing is everything," Mr. Nelson said. "Our board had been considering whether to sell for several years. We decided our earnings were not going to get any better than they had been." And with new competition and changing technology, he faced the prospect that the bank's profits and the price it could fetch would only decline.

With big banks like the Banc One Corporation of Columbus, Ohio, and the Nationsbank Corporation of Charlotte, N.C., scouring the country

Continued on Page A12, Column 1

Wave of Mergers Is Transforming Banking

Continued From Page A1

for acquisitions, there was hardly a bank big or small that had not considered selling. But until recently there was no hurry. In fact, with hostile takeovers rare in banking, executives were able to relax in executive suites, without pressure to cash out until they wanted.

This year, though, more banks like West One decided that the timing was right to sell. Three reasons stand out for the wave of bank mergers.

First, it is harder for bankers to increase their profits, now that they have finished cleaning up the problems of the late 1980's and have cut costs as much as they could. As for new lines of business, all but the largest banks have been wary of investing in such avenues as computer banking and mutual funds.

Second, the big banks like Banc One, which were already hungry for acquisitions, have been turning up the heat. Instead of waiting for their targets to decide to sell, as used to be the case, the acquiring banks have tried to force their hands with aggressive bids. The big banks especially want to prevent medium-sized banks from merging with each other and creating institutions too big for their grasp.

And third, stockholders have agitated with managements to sell at a premium rather than pursue defensive mergers, which do not carry a premium.

"Stockholders are becoming more active, with no tolerance for any kind of mistake or problem," said Richard M. Kovacevich, chairman of the Norwest Corporation of Minneapolis. "Banking is still more cozy than other industries, but it is a lot less cozy than it was three or four years ago, or even a year ago."

Some bankers, like those at New Jersey's two biggest banks, First Fidelity and Midlantic, decided it was time to cash out. Their buyers, the First Union Corporation of Charlotte, N.C., and the PNC Bank Corporation of Pittsburgh, respectively, decided it was worth paying a steep price to maintain their rapid growth. Similarly, First Bank System of Minneapolis bought Firstier Financial of Omaha earlier this month for $700 million.

At other banks, like First Chicago and NBD Bancorp of Detroit, the managements have chosen "mergers of equals," in which similarly sized institutions combine to create a far larger entity less vulnerable to a hostile takeover.

Even some banks with stock prices high enough to fend off hostile suitors have become interested in such combinations as a way to expand without either bank having to pay a huge takeover premium.

"There are some mergers of equals that make sense," John F. Grunhofer, chairman of First Bank Systems, said. But many of those never get off the ground, he added, because the two banks cannot agree on such "social issues" as who will be in charge, where the headquarters will be and what name to use.

That was what torpedoed the Bank of Boston's various efforts to merge with the regional rival Fleet Financial Group, with the Mellon Bank Corporation of Pittsburgh and, more recently, with the Corestates Financial Corporation of Philadelphia. That merger was abandoned last month before it was announced, after word of the deal was leaked and

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prompted criticism by investors and a brief hostile bid for Bank of Boston by Banc One of Ohio, which was withdrawn after the Corestates deal collapsed. The string of botched mergers cost the Bank of Boston chairman, Ira Stepanian, his job.

Mergers can be tough on the employees and communities, and will affect consumer habits.

A year ago, for example, Detroit had three major independent banks. Now NBD will be run from Chicago, and Michigan National was bought by National Australia Bank, leaving only Comerica Inc.

Not every bank executive feels the pressure to do something. Many who have found some profitable source of growth should be able to preserve their independence.

"I think the sellers are more pessimistic about the banking industry than I am," said Stephen A. Hansell, chief executive of the Hibernia Corporation in New Orleans, which has $6.3 billion in assets.

In many ways, the deals signify a changing of the guard. The current generation of bank chiefs came to power in the late 1980's and early 1990's, when banks were failing. The victims were mostly the highfliers who got too loose with their lending, especially to real estate developers. Then the industry rediscovered caution.

With a recovering economy and falling interest rates, bankers could look like heroes simply by cutting costs and not making new mistakes. Today, the industry seems to be in its best shape in decades.

But as suddenly as it arrived, that era is coming to a close. Many bankers have found they cannot increase their profits simply by cutting costs; they have to increase revenue somehow, and not all bank executives are up to the task.

As bright as the profits are today, most bankers see their industry's prospects as bleak, leaving room for only a few to thrive. Banks continue to lose their share of the nation's financial assets to mutual funds and other investments.

Moreover, what was once a bank's biggest advantage — a branch on every major street corner — has increasingly been viewed as an albatross in an era of automated banking. "At some point the cost of bank branches will be harder to justify," Mr. Nelson of West One said.

By selling now, not only did Mr. Nelson secure a high price for his shareholders — nearly twice the bank's book value — but also jobs for many of West One's executives in the combined company. Mr. Nelson became president and chief operating officer.

For many years the big banks played a waiting game, leaping to acquire smaller institutions when they got into trouble or when their chairmen neared retirement age.

"There are hundreds of banks out there we are talking to at any point in time," Mr. Kovacevich of Norwest said. "At any point, we are in negotiations with 40 or 50 banks, but we may buy 5 or 6 of those."

But now these big banks are getting itchy. Their stock prices have run up during the bull market, making it possible for them to buy banks for stock without diluting the earnings of existing shareholders. With that advantage, "the big guys are trying to figure out how quickly they have to move before they find all the good franchises gone," said John Duffy, the head of the bank merger practice at Keefe Bruyette & Woods.

More pressure has come from big investors in bank stocks.

Michael Price, an investment manager, put the squeeze on Michigan National until its management sold to National Australia. And now he has a big position in Chase Manhattan and has called on the bank to take steps to benefit shareholders, including a possible breakup.

Shareholders are becoming reluctant to take no for an answer. "If your four or five biggest shareholders start pressuring you to sell," said Doug Mercer, an investment banker at Donaldson, Lufkin & Jenrette, "as a board member you better have a pretty good reason why you aren't going to sell."

BY THE NUMBERS

The Big Money Mergers

A look at the financial statistics of the big banks planning to merge.

Acquiring bank / Acquired bank	Price paid for acquired bank	Contribution of each bank to new merged entity: Assets on June 30 (In dollars; as a percent)	
First Union	$5.56 billion	$83.1 billion	70%
First Fidelity Bancorp		$35.4 billion	30%
First Chicago	$5.14 billion	$75.3 billion	61
NBD Bancorp		$48.1 billion	39
Fleet Financial	$3.65 billion	$51.3 billion	59
Shawmut National		$36.0 billion	41
PNC Bank	$3.03 billion	$62.8 billion	82
Midlantic		$13.7 billion	18
U.S. Bancorp	$1.57 billion	$21.3 billion	70
West One Bancorp		$ 9.2 billion	30

Source: SNL Securities

The New York Times

AB # p. 1 + 24

Monday, August 21, 1995

Rising Consumer Debt Could Cloud Outlook for Economy

By GORDON MATTHEWS

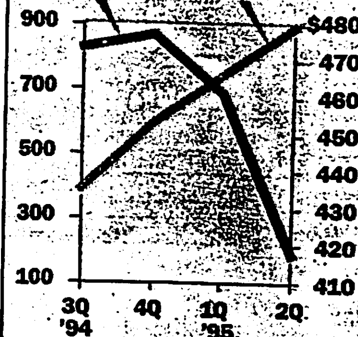
Are the nation's consumers tapped out?

The answer to that question is important not only for bankers, but as a guide to the future strength and direction of the economy.

Consumer credit has grown sharply over the past several years. Recently, however, delinquency rates have been edging up, and job growth has plummeted.

"We went on a credit card borrowing spree late last year. A lot of marginal borrowers were taken on, and now they are having some difficulties making payments," said Philip Braverman, chief economist at DKB Securities Corp., New York.

"That helped inflate retail sales, but the jobs and the incomes aren't there. And if those aren't there, the economy cannot be sustained by credit indefinitely," he said.



See back page

to buy AutoFinance Group for *$325 million. Analysts likened the move to the Barnett Banks' purchase last year of Equicredit Corp., a subprime home equity lender, for $332 million.*

Adam Hitt, a principal with Alex. Brown & Sons, which has underwritten a number of the recent auto finance initial public companies in this category, he said, include First Merchants, Muncie, Ind., Consumer Portfolio Services and Westcorp., both of Irvine, Calif., Regionals Acceptance Corp., Greenville, N.C. and Americredit Corp., Fort Worth, Tex.

"What has happened in banking in the last few years is the interested in the subprime business.

There are hurdles, of course.

Keycorp paid 32 times 1995 earnings for AutoFinance, sparking criticism from the bank's shareholders who viewed the price as excessive.

Subprime auto finance companies also spring from an entrepreneurial culture, one that might tors are emerging everywhere.

Consequently, Mr. Hitt warned, it is essential for banks to distinguish between fly-by-night operations and those with established track records.

Most of these companies are bound to make mistakes as they use capital from their IPOs to expand into new regions and exing notice.

Montgomery Securities, Alex. Brown & Sons, Donaldson Lufkin & Jenrette, and William Blair are among the investment firms that have added coverage of these companies.

The question now is whether banks will look closely before they leap. □

Rising Consumer Debt Could Cloud Outlook for the Economy

Continued from page 1

Economic analysis

The Federal Reserve's Open Market Committee will be mulling these trends tomorrow as it meets to assess business conditions and consider whether to change interest rates.

Consumer spending underpins two-thirds of the nation's economy, as measured by gross domestic product.

"I keep my eye on consumers. Wherever they're going, that's where the economy is going," said economist and money manager A. Gary Shilling.

Consumer borrowing and spending during the final half of last year sparked strong GDP growth and led the inflation-wary central bank to apply the brakes by raising rates more than the financial markets had expected.

GDP growth nearly ground to a halt in the second quarter this year, and the Fed lowered rates a notch in July. Recently, however, the economy has appeared to quicken again, with the usual help from consumers.

"The consumer is never really quite tapped out in our economy," said Allen Sinai, chief global economist for Lehman Brothers, New York. "Trendwise, consumer spending rises about 2.5%

Sung Won Sohn
Chief economist, Norwest Corp.

Philip Braverman
Chief economist, DKB Securities Corp.

a year after inflation."

Mr. Sinai said his analytical yardstick of how healthy U.S. consumer balance sheets are shows they "have deteriorated somewhat from a year ago but are in far better shape than they were five years ago."

Lehman Brothers' index of consumer financial positions rose to an estimated 209.9 in the first quarter, up from 205.6 at the end of 1994 and up from its cyclical low level of 181.4 at the end of 1993.

The weighted index is composed of eight debt and debt-related variables.

High levels of the index indicate high levels of consumer financial stress and predict lower consumer spending than otherwise would occur.

Since the low in the fourth quarter of 1993, the index has risen only slowly, Mr. Sinai said, surrendering less than a third of the improvement seen in consumer balance sheets since the fourth quarter of 1990.

"The one thing that sticks out like a sore thumb is consumer installment debt," the economist said. It has risen from 16% of disposable income in May 1993 to 18% in February 1995.

But Mr. Sinai thinks a sizable chunk of this growth may be due to the trend toward using credit and charge cards as a means of settling transactions previously handled by cash or checks.

Still, some other economists are wary.

"I divide consumers into 'debt haves' and 'debt have-nots,' " said Sung Won Sohn, chief economist at Norwest Bank, Minneapolis.

Much of the recent addition to consumer debt was incurred by the debt haves, consumers who generally are already carrying a significant amount of debt, including credit card debt.

On top of a softening job market, he said, consumers are getting a double whammy of rising interest payments on installment debt and rising taxes as a share of take-home pay. "This limits the consumers' ability to spend, thus limiting economic growth."

Not that the Norwest economist expects a recession to begin soon. He and Mr. Braverman both anticipate subpar growth by the economy will prompt the Fed to begin cutting interest rates again later this year.

Indeed, Mr. Braverman thinks the Fed will have to keep slicing rates through next year to keep the slow-chugging economy from sputtering into recession.

The DKB economist thinks a recession is possible next year, a presidential election year, "which would make life miserable for both the Fed and the politicians."

Mr. Shilling, who is based in Springfield, N.J., also sees a good chance of a recession, perhaps a deep one, beginning at the end of this year.

"Consumers are cautious because of the lack of job openings resulting from ongoing corporate restructuring, defense cuts, and the delayed effects of earlier Fed tightening," he said.

"Given their high levels of debt," he noted, "they seem likely to curtail outlays enough to precipitate the usual chain of recessionary events." □

Key Rates

	8/18	Week ago	Year ago
Federal funds	5 11/16	5 11/16	4 11/16
Prime rate	8.75	8.75	7.75
Broker loan	7.50	7.50	6.50
Discount rate	5.25	5.25	4.00
CDs[1]			
3-month	5.04	4.99	4.11
6-month	5.10	5.00	4.40
1-year	5.15	5.00	4.75
Eurodollars[2]			
3-month	5 7/8	5 13/16	4 15/16
6-month	5 15/16	5 13/16	5 1/4
1-year	6 1/16	5 7/8	5 3/4
Dealer Commercial Paper[3]			
1-month	5.80	5.77	4.78
3-month	5.75	5.70	4.90
6-month	5.68	5.62	5.18

Late afternoon quotes, New York market. [1]High offering rates at selected NYC money centers. [2]Late London bid [3]AA rating of equiv.

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The Wealth Gap Is Real and It's Growing

By Paul Krugman

STANFORD, Calif.

Ten years ago, a skeptic could still question whether America was becoming a radically less equal society. But since then, the doubts of cautious economists have been swept away by an ever-growing torrent of evidence: Census data, household studies, labor-market surveys and, of course, the startling contrasts of wealth and poverty obvious to anyone with open eyes.

The reality of widening disparities is no longer a hypothesis. It is simply a fact. What, if anything, should we do about this surge in inequality? Reasonable people can disagree about the solution, but they cannot disagree about the fact.

Yet in the last few months, there has been a sustained effort by conservatives to deny this uncomfortable reality. The latest campaign was apparently initiated by anger over a new book, "Top Heavy: A Study of the Increasing Inequality of Wealth in America," by Edward N. Wolff of New York University.

How can one deny the obvious? Let us count the ways.

Do spurious calculations. A favorite tactic of conservative writers is to produce data that purport to show that the wealth of the average rich family — invariably defined as any family with an income exceeding $50,000 — has not risen as fast as that of less affluent Americans.

But their calculations are entirely spurious, for two related reasons.

First, $50,000 a year does not make a family rich. More than one-third of American families can claim that income. But "rich" means something else: at the least, it means being part of the 10 percent of families who own 70 percent of the nation's wealth. Those who think that statistics about people who make $50,000 or $60,000 a year are getting at the truth about how the upper class is doing have no idea how rich the rich really are.

Second, Federal Reserve statistics on average wealth by category of income cannot be used to measure trends. The reason is that the categories mean different things in different years: half a century ago, someone with a $50,000 income was upper class; today, he is middle class.

While Federal Reserve data that track the concentration of wealth are vulnerable to creative misinterpretation, the statistics showing a drastic increase in the inequality of income — drawn from many different sources — are completely unambiguous. Whatever you think about the distribution of wealth, the inequality of income has increased.

Pretend that it's good news. A recurrent theme among conservative apologists for growing inequality is that our society is not pulling apart but coming together. The upper class, they say, is not pulling away from the middle class; it is simply growing as more and more middle-class people gradually upward.

> Conservatives may deny it, but facts are facts.

But the truth is the upper class is indeed pulling away from the middle class. In fact, income is becoming more concentrated all the way up the scale.

It's not just that the top 20 percent have gotten richer compared with the rest. The top 5 percent have gotten richer compared with the next 15 percent; the top 1 percent have gotten richer compared with the next 4 percent, and there is pretty good evidence that the top 0.25 percent has gotten richer compared with the next 0.75 percent.

The idea that wealth is spreading rather than becoming ever more narrowly concentrated is comforting, but utterly untrue.

Invoke Horatio Alger. In his new book "The Freedom Revolution," the House majority leader, Richard Armey, offers numbers that purport to show that there is so much upward mobility that the distribution of income doesn't matter — that someone in the bottom 20 percent of the population is more likely to be in the top 20 percent after a decade than to remain in place.

Mr. Armey offers no source for his numbers, but they are familiar to researchers in the field. They come from a hastily concocted study done by Bush Administration officials in 1992, a study that experts immediately ridiculed. Some of the experts were reduced to helpless giggles when they realized that the median individual who moved from the bottom to the top 20 percent was only 22 years old at the beginning of the study period. As one labor economist remarked scathingly: "This isn't your classic income mobility. This is the guy who works in the college bookstore and has a real job by his early 30's."

Blame the messengers. Many of the recent conservative tracts on income inequality attack those who bear the bad news as politically motivated. The targets include not only the economists who want to do something about it but the researchers who carefully construct the data, and even the reporters who write about the research.

The news about growing inequality comes not only from the Census Bureau (hardly a leftist clique) but also from studies published in such places as the Journal of Political Economy, a highly respected and often inscrutably technical publication of the University of Chicago, which has rarely been accused of fomenting class warfare.

The widening of inequality is beyond doubt. It has been as firmly established by evidence as the fact that smoking causes cancer. But many influential conservatives cannot bring themselves to acknowledge inconvenient facts. Is their doctrine so fragile that they fear it cannot survive the truth? ☐

Paul Krugman, an economist, is author of "Peddling Prosperity" and "The Age of Diminished Expectations."

Letters

Shock therapy for Russia; Emily Dickinson on r

N.Y. Times Book Review 8/13/95, p. 31

Russia Is Shocked

To the Editor:

John Lloyd's celebration of "How Russia Became a Market Economy," by the Swedish economist Anders Aslund (July 23), brings us full circle on the "shock therapy" policy he helped design with Harvard's Jeffrey Sachs.

Shock therapy, which involved the quick-and-dirty demolition of the old system before a new one had been built, was launched in early 1989 with the editorial support of The New York Times. Mr. Aslund now writes a definitive "proof" that the policy succeeded, except that it would have succeeded more if there had been more shock — defined as "a rapid reduction in the budget deficit." The Times, in turn, assigns the book to Mr. Lloyd, who celebrated the Aslund-Sachs "shock therapy" during his tenure as Moscow bureau chief of The Financial Times of London.

It seems one big happy family. The only reservation Mr. Lloyd has is that while there is now a market in Russia, "the rise in overt crime and corruption (which reform has not caused, but has certainly not cured either) threatens not just the reforms but the state itself." Those of us who fought the Anders-Sachs method from its inception did in fact argue that monetary reform had to precede the destruction of the state's command mechanism or civil chaos would follow. This, in order to permit a private banking system to replace the centralized allocation of capital.

Instead, the "market" economy created is merely a black market that lives according to the law of the jungle. Beijing, on the other hand, rejected cold-turkey capitalism for the careful conversion that is being cheered by its people. The editors of The Times only kid themselves with this rosy review of Mr. Aslund's fiasco.

How is it that the same editorialists who thrill to shock therapy in Moscow are correctly horrified when Republican leaders in the 104th Congress beat the drums for shock therapy at home? Drastic action to balance the national budget in either country is an act of intellectual desperation. It invariably puts the burden of adjustment on the poorest and weakest people in society.

JUDE T. WANNISKI
Morristown, N.J.

Simple Rules for a Simpl[e]

To the Editor:

So salubrious is Robinson Crusoe's island that Crusoe can live entirely off the abundant coconuts. But the generous yield requires annual difficult labor, so the arrival of Friday is welcome: he is enslaved and put to work, and Crusoe lolls and gets all the coconuts except those few required for Friday's subsistence and a bit of motivation.

One day there washes ashore a copy of Richard A. Epstein's "Simple Rules for a Complex World" (July 16), and Crusoe is required to liberate Friday by Mr. Epstein's Rule 1: ONE OWNS ON

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Satan Won't Go

To the Editor:

Leslie Houlden warns in his review of Elaine Pagels's book "The Origin of Satan" (June 18), "This demon will not go

usual book. But it is necessarily one-sided because it concentrates — as does the book — on the use of demonology in establishing who the enemy is in Jewish and Christian tradition as well as history. Ms. Pagels may not state her argument with "excessive single-mindedness," as the reviewer asserts, but she does seem to limit her thesis to the strictly religious and to the early Christian period. That is not so much a criticism as an opportunity to apply her argument to the present day, a step I trust she would approve.

Mr. Houlden praises the author for her handling of orthodoxy. Therein lies the critical issue, I believe. For above all, Satan has been employed as a power tool in the enforcement of orthodoxy: religious, political, social, scientific. Maintenance of the orthodox view (that is, control) has been accomplished by burning witches and books, engendering fear of hell and retribution, developing rituals

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Economic Scene | Peter Passell

A mystery bankers love: How do credit cards stay so profitable?

HAD any "pre-approved" offers for credit cards in the mail recently? If not, you must be a hermit or a notorious deadbeat: The average household received two solicitations a month in 1994.

The reason all those nice banks are lining up to lend you money is no mystery. The profit on credit card operations, according to research by Lawrence Ausubel, an economist at the University of Maryland, is almost five times the overall profit rate in banking. Last year, eight of the top nine commercial banks ranked by return on assets specialized in credit card loans.

In a free market, this isn't supposed to happen. If the business is immensely profitable — and that profitability is no secret — why hasn't wide-open competition forced banks, at best, to offer lower interest rates to consumers or, at worst, at least to dissipate their excess profits in ever greater spending for promotion?

Professor Ausubel's latest paper, presented last month to the National Bureau of Economic Research, buttresses his earlier finding that banks can charge uncompetitive rates on credit cards because consumers don't really believe that they will end up paying them. This, however, must be only part of the answer to the broader question of how competition can coexist with stunning profits in an industry offering a rather conventional service.

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Mr. Ausubel first made waves inside his profession with a 1991 article in the American Economic Review that explained the high and "sticky" interest rates paid on credit card balances as a byproduct of consumer myopia. Credit card rates have since edged down, Mr. Ausubel says, and new cards are generally issued with variable rates. But the "spread" between what the banks pay for their own funds and the average rate they charge for credit cards — typically, 10 percentage points — has barely budged.

Niculae Asciu

Equally striking, there is no erosion in the profitability of credit card operations. Indeed, notes Lawrence White, a former bank regulator who teaches economics at the Stern School of Business at New York University, credit cards generate much of the profit for banks now squeezed by competition from all sides.

New data support Mr. Ausubel's hypothesis that consumers do not expect to use their cards to borrow, and often do not even admit it when they do. Extrapolating from surveys, he discovered that Americans claimed they owed a total of $70 billion on their credit cards in 1992 when in fact they owed $182 billion.

Smart banks have learned to exploit this wishful thinking. While their interest rates remain uncompetitive compared with other loans, successful cards are now marketed with flashy extras — below-market teaser rates, product discounts, insurance, frequent-flier miles, even cash rebates — and rarely charge annual fees.

Robert Frank, an economist at Cornell University, notes that Mr. Ausubel's findings are consistent with other research on behavior in the face of temptation — of impulsive consumption of food, alcohol and tobacco. "You know it's stupid," he explains, "but the pain comes later." It follows that borrowers cope with the guilt of compulsive shopping by forgetting the after-effect.

Still, what's more puzzling is that the excess gains are not burned up in the competition among card issuers to corral a bigger share of the highly profitable shopping addicts. Despite spending billions each year trying to lure new credit card customers and keep old ones, issuers still managed to earn 30 percent-plus returns on equity in the last decade. That is more than double the average return on investments by corporate America, with no greater risk.

Mr. Ausubel speculates that these persistent "supernormal" profits are a result of rapid innovation in marketing, much the way supernormal profits are the norm in markets dominated by rapidly changing technology — electronics, computer software, pharmaceuticals and the like. Consumers sign up for cards that offer the cleverest gimmicks, and then pay excessive interest for years before being seduced by an even more clever gimmick. There is fierce competition. But the prize goes to the creator of the flavor of the month — not to banks that deliver more service for less money.

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This is not a pretty picture of free markets at work. Nor, for that matter, is it a particularly plausible one: Could the skills in marketing credit cards really be so specialized — and so difficult to imitate — that they account for most of the profit of one of America's most profitable industries?

If anything, there's a lesson for the economic profession itself in this tale. Much as they don't like to admit it, economists don't know as much as think they do about what makes markets tick. "At some point," Mr. White of New York University concedes, " you've just got to say, 'I don't understand this thing.' "

By STEPHANIE ST

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The Danger of Bigger Trouble With the Chinese

By Walter Russell Mead

The downhill slide in relations between the United States and China is a dangerous development. The friction isn't the result of amateurish missteps by the United States or Congressional demagoguery on Taiwan, nor does it reflect paralysis in China over the struggle to succeed Deng Xiaoping.

Something much deeper and much worse is at work: a potential clash between what the two countries perceive to be their vital interests. Unless China breaks up after Mr. Deng dies, or suffers a Soviet-style economic implosion, tensions between the two countries seem fated to grow.

This is hard for Americans to understand. No one in the United States wants a diplomatic confrontation, much less a war, with China. Yes, read them stiff lectures on human rights, Americans say. After all, we criticize many countries for human rights violations; it is our national pastime. Yes, fight for our economic interests in trade negotiations. That's business.

But the public seems to have no sense that a broader, deeper confrontation seems to be brewing. American diplomacy looks increasingly sinister from Beijing.

China is emerging from two centuries of weakness and humiliation. It is finally mastering Western technologies and economic ideas. Many Chinese feel that at long last they are in a position to command the respect and consideration they deserve.

But everywhere China looks, America gets in its face. The United States welcomes the Dalai Lama and the President of Taiwan. It buries the hatchet with Hanoi and talks about "mutual interests" with the Vietnam it once loathed and fought. It stiffens the spine of the Southeast Asian countries in their dispute with China over ownership of the potentially oil-rich Spratly Islands. It roars like a lion over human rights violations in Chinese Tibet but squeaks like a mouse about Boris Yeltsin's attack on Chechnya. It continues its security cooperation with Japan and, along with South Korea, seems determined to increase its contacts and influence in North Korea.

Not content with all this, now the United States is knocking on China's back door. American oil executives are negotiating deals and acting as de facto diplomats in Central Asia.

The more paranoid elements in the leadership in Beijing talk about American "encirclement" of China. But even level-headed Chinese see a persistent pattern of American opposition to their legitimate aspirations and interests.

The United States lectures about free trade even as it opposes China's drive to join the World Trade Organization. We don't think about history much, but the Chinese remember that American and British merchants have been lecturing China about free trade since the 1830's, when they denounced China's efforts to ban "free trade" in opium.

Now, the Chinese feel, American commercial interests are as hypocritical and self-serving as ever. China has discovered ways to make industrial goods that are competitive with American products; what does the United States do but whine about its trade deficit and threaten China with sanctions?

It is the same story on human rights. American missionaries first showed up in China at about the same time as the merchants. Their contempt for Chinese civilization and culture was obvious as they lectured the people about the poor treatment of women, the lack of civil liberties and the general inadequacy of everything Chinese. At the same time, the United States was a slave-holding society that was busy obliterating North America's native cultures. The United States discriminated against Chinese immigrants and put their children in segregated schools.

The Chinese still feel that some of the moral energy Americans devote to discussing China's shortcomings could be usefully diverted to perfecting conditions in the United States.

American hostility seems more surprising to the Chinese because we were so recently so warm. In the

As they grow stronger, we must grow wiser.

1970's, once President Richard Nixon and Henry Kissinger broke the ice, China was a strategic partner against the Soviet Union. The political relationship cooled off in the late 1970's, but the economic relationship steadily improved. China was every businessman's favorite emerging market, and under President George Bush the United States had relatively few complaints about Chinese trade practices.

China today is a much freer society than the place Richard Nixon visited when the Gang of Four still ruled. It is a far better place for foreigners to do business than it was 10 years ago. So why, the Chinese wonder, are Americans so critical?

The United States has a different perspective, seeing the relationship in the context of our wider Asian

policies. During the 19th and 20th centuries, American power and responsibility on the Pacific Rim grew steadily. After World War II, the United States assumed the same position in Asia that it held in Europe: guaranteeing stability by insuring that no one country became strong enough to dominate the rest.

Now that the Soviet Union has disappeared, China is becoming strong enough to challenge the Pacific Rim balance of power. Already, Americans worry, it is throwing its weight around in the region. By threatening its neighbors over the Spratly Islands and by taking a belligerent tone with Taiwan, China seems to be acting like the kind of bad neighbor that the United States needs to deter.

Yet we also see the Communist leadership as clearly unstable. Many of China's best and brightest have been alienated by the regime; the struggle to succeed the aging Deng Xiaoping reveals the weakness of its political institutions and the fragility of its social order.

China's record abroad is equally troubling. Even sympathetic observers think China may not really know what it wants. Its policy lurches from confrontation to conciliation, and any extension of Chinese influence tends to have a destabilizing effect. Under the circumstances, the United States and other countries have no choice but to treat China with caution.

Growing Chinese strength worries China's neighbors, causing them to strengthen their ties with America. This worries China, which tries to parry American diplomacy and break out of the perceived encirclement. Washington responds with greater efforts, and so on.

Cycles like this can lead to wars. In the early 20th century, Britain feared Germany's growing power, and Germany feared British encirclement. Both sides lurched toward a confrontation, each sincerely convinced that it was acting defensively and from the noblest of motives.

The United States and China will have a hard time reaching an understanding. Neither country trusts the other; their political, economic and cultural systems are so different that they have trouble understanding each another.

If China stays united and continues to grow, it will indisputably become the leader of its region. The Chinese need to learn that power doesn't flow from the barrel of the gun. Leadership and dictatorship are not the same thing. China needs to find ways to avoid confrontation as it consolidates its new position. Economic advantage, political sensitivity and stable institutions can create a positive international environment for a strong, rich and united China.

Beyond this, China needs to develop a vision of its place in the region and the world. It needs to safeguard its interests without threatening the neighbors — and without triggering American instincts of opposition.

The United States must also do some thinking. What is the American vision for China's role in the world? How can we design a special relationship with China? How can we balance China's right to an enhanced regional profile with our own interests and commitments?

There are some steps we can take immediately. The most important have to do with Taiwan. The one-China policy is the cornerstone of the United States-China relationship and should be reaffirmed by a Congressional resolution. Washington should also refrain from responding to Chinese military maneuvers with shows of force.

We should also give our missionary instincts a rest. We have left China in no doubt about our dissatisfaction with its human rights policies; it might be worth changing the subject for a while.

In the longer term, by supporting quick Chinese membership in the World Trade Organization on reasonably favorable terms, the Clinton Administration would not only ease Chinese concerns but also engage China in a multilateral forum for discussions of trade problems.

American hard-liners will denounce these proposals as signalling weakness. Perhaps. But if China were to meet our conciliation with intransigence, we would be free to respond with tougher measures. Both countries have so much to lose from a bad relationship, and so much to gain from improving it, that the United States risks little by trying improve the tone. □

Walter Russell Mead is a fellow at the World Policy Institute at the New School.

Low Ranking for Poor American Children

U.S. Youth Among Worst Off in Study of 18 Industrialized Nations

THE NEW YORK TIMES NATIONAL MONDAY, AUGUST 14, 1995

P. A9

By KEITH BRADSHER

WASHINGTON, Aug. 13 — Poor children in the United States are poorer than the children in most other Western industrialized nations, as young Americans suffer the brunt of several trends toward greater economic inequality, a new study shows.

Only in Israel and Ireland are poor children worse off than poor American youths, according to the study, an analysis of 18 nations by the Luxembourg Income Study, a nonprofit group based in Walferdange, Luxembourg.

The results are the most comprehensive of several recent analyses, and are particularly striking because the United States has the second highest level of economic output per person of the countries examined, after Luxembourg itself, and has the most prosperous affluent children of any of the 18 nations.

It may not be surprising that childhood poverty is worse in the United States than in Scandinavia, where governments have racked up huge national debts while trying to maintain elaborate social safety nets. But the United States also ranks below countries like Italy, which has a considerably smaller economy per person and has less generous social policies than many northern European nations.

The United States appears to have sunk through the rankings over the last 30 years, although no conclusive data are available now, said Timothy M. Smeeding, one of the study's authors and director of the Luxembourg Income Study. The American lead in overall prosperity has dwindled since the 1960's, income inequality has risen briskly in the United States and child poverty spread here in the 1970's and 1980's, although it may have leveled off in the early part of this decade.

Child poverty has also risen in Britain and Israel, while showing relatively little change in Continental Europe, according to the latest study.

Some conservative economists have questioned the validity of studies that attempt to compare levels of income and distribution of wealth among nations with somewhat different economic systems and societies. There is general acceptance within the field, however, of the idea that the United States has proportionately more of its children in poverty than other affluent countries. The debate revolves instead around what to do about it.

The results of the Luxembourg Income Study report, which is based on census survey data from the various countries, are consistent with less statistically detailed work by other social scientists.

The study comes as Congress is deciding whether to limit Federal spending on various welfare programs. Senator Bob Dole of Kansas, the majority leader, tried to push welfare legislation through the Senate last week, but ended up postponing action until after Labor Day following strong resistance from Democrats and from conservatives within his party.

During a press conference on Thursday, President Clinton expressed strong concern about stagnant incomes, particularly for less-affluent Americans. "We've got to grow the economy and raise incomes," he said. "That's why I want to raise the minimum wage, that's why I want to give every unemployed worker or underemployed worker the right to two years of education at the local community college, that's why I'm trying to have a tax cut that's focused on child rearing and education: to raise incomes."

Mr. Smeeding said there appeared to be several reasons why the United States had such extreme poverty among children.

The United States has the widest gap between rich and poor, he said. The United States also has less generous social programs than the other 17 countries in the study, which are Australia, Canada, Israel, and 14 European countries: Austria, Belgium, Britain, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Sweden and Switzerland. The study did not include several Western European nations like Greece, Spain and Portugal that have very poor children but limited data.

American households with children tend to be less affluent than the average American household, a pattern that is not true in many other countries.

This trend may reflect that American mothers are less likely than European mothers to return to work quickly after childbirth, partly because inexpensive, high-quality child care is more widely available in Europe, said Lee Rainwater, the research director of the Luxembourg Income Study and the co-author with Mr. Smeeding of the latest report. The Luxembourg group sent copies of the report to prominent social researchers last week and will make it more broadly available in the coming days.

Some conservative analysts question whether international comparisons of prosperity should even be attempted. They point to the many differences among nations' economies and societies.

There are more poor children in the United States than in many affluent countries, but that partly reflects the high number of poor immigrants and unwed teen-age mothers here, said Douglas J. Besharov, a resident scholar at the American Economic Institute, a conservative research group here.

"Is there more poverty in a big, diverse country like ours than in Western Europe?" he asked. "The answer is yes."

He and other conservative economists argue that the price the other countries pay for avoiding extremes of childhood poverty may be slower economic growth, which, they assert, leads to lower living standards for all. A large chunk of European social assistance to young families takes the form of generous unemployment benefits that have eroded incentives for people to work, Mr. Besharov said.

The Luxembourg Income Study is financed by the National Science Foundation in Washington and similar agencies from 18 other governments. Its staff has been working for the last decade to develop ways to make reliable international comparisons. The group is a repository for computerized data on income distribution from 25 countries around the world, which it makes available for free to social researchers.

In addition to his work with the study, Mr. Smeeding is an economics professor at Syracuse University and one of the nation's leading experts on income calculations. While he personally favors expanded social spending in the United States, he is generally regarded in the field as an undogmatic thinker. Mr. Rainwater is a professor emeritus of sociology at Harvard University and the author of many books on poverty.

Their study is critical of Republican efforts to cut American social spending now.

The study compares incomes of poor and affluent households with children. The figures include not only after-tax wages and other personal income but also cash benefits from the government, like food stamps and the tax credit on earned income for low-income working parents with children. The calculations take into account differences among countries in the size of families and in the cost of living.

The figures do not include free government services, like the free medical and child-care serv[illegible]

available in many European countries.

Sheila B. Kamerman, a professor of social policy and planning at Columbia University, said that for this reason, the latest analysis may have underestimated the extent to which poor American children lag in income. "If you were looking at in-kind benefits as well as cash benefits, the situation in the U.S. would look even worse," she said.

Professor Kamerman and Alfred J. Kahn, another Columbia University social policy professor, published a lengthy study two weeks ago reviewing social programs in Britain, Denmark, Finland, France, Germany, Italy and the United States and found that American poor children received the least help.

Poor children in Denmark do particularly well in comparison to poor American children. Vita Pruzan, the director of the children, youth and family research division at the National Institute of Social Research in Copenhagen, said in a telephone interview that in reducing child poverty, the Danish Government had found it particularly effective to provide free obstetric and nursing services.

Denmark also makes a particular effort to help single mothers who do not receive child support payments from the fathers of their children. "If the father is absent and doesn't pay, the state will pay what he is supposed to pay," Dr. Pruzan said. "The state tries to collect the money from the father, but that is not her problem."

SORTING IT OUT

The Gap Between Rich and Poor Children

The latest research indicates that poor children in the United States are poorer than the children in most other Western industrialized nations because the gap between rich and poor is particularly large in the United States and because welfare programs here are less generous than abroad. Households with children in the United States also tend to have lower incomes than the national average, a pattern that is not true in many other nations.

The bars at right represent the gap between rich and poor children in Western countries for which detailed data are available. The left end of a bar is the household income of poor children; the right end, affluent children. All figures are in 1991 dollars, with foreign currencies converted using adjustments for national differences in purchasing power.

	Poor household with children[1]	Length of bars represent the gap between rich and poor children	Affluent households with children[2]
Switzerland	$18,829		$59,502
Sweden	18,829		46,152
Finland	17,303		41,991
Denmark	17,268		46,326
Belgium	16,679		47,262
Norway	16,575		43,829
Luxembourg	15,396		50,071
Germany	15,257		51,874
Netherlands	14,529		42,616
Austria	14,321		39,911
Canada	13,662		56,174
France	13,003		44,835
Italy	12,552		44,280
Britian	11,581		43,933
Australia	11,512		49,863
United States	**10,923**		**65,536**
Israel	7,871		33,392
Ireland	6,692		27,185

$0 $20,000 $40,000 $60,000

[1] After-tax income, including Government benefits like food stamps or the Earned Income Tax Credit, for a family of four that includes children and that is poorer than 90 percent of the households in the country and more affluent than 10 percent of the households.

[2] After-tax income, including any Government benefits, for a family of four that includes children and that is more affluent than 90 percent of the households in the country and poorer than 10 percent of the households.

Source: Luxembourg Income Study

Poor children in Italy are also better off than poor American children, even though the median income in Italy is considerably less than in the United States. Free child care for some poor children and a low-cost health care system have helped, said Patrizia Ghedini, the head of the family issues department of the regional government for the area of northern Italy around Bologna.

But in Italy, the gap separating rich and poor is also smaller than in the United States. According to the Luxembourg Income Study report, a poor household with children near the bottom of the income scale in Italy earned $12,552 in 1991, while an affluent household with children near the top of the scale earned about $44,280. For the United States, the comparable figures that year were $10,923 and $65,536.

Economic Viewpoint

BY RUDI DORNBUSCH

AND YOU THOUGHT SOCIAL SECURITY WAS IN TROUBLE...

KATHERINE LAMBERT

TIME BOMB: Canada, Italy, and Japan face retirement obligations several times more onerous than the U.S.'s. One solution? Mandatory private savings

This fall, Congress will try to ax budget deficits that loom as far as the eye can see. Without such action, the Congressional Budget Office projects that rising medical expenses and a shrinking social security surplus will, by 2005, widen the deficit to 4.1% of gross domestic product and the ratio of debt to GDP will climb to 60%. Balancing the budget would make room for more investment and reduce the chances that financial markets will have to shoulder the burden of heavy deficit financing. What's more, balancing the budget need not create a slump or a recession. True, the government will spend less, but interest rates will fall, and private spending will take up the slack.

America's fiscal problems sound ominous, but there is a surprise: With respect to its finances, the U.S. is one of the healthiest economies. Many other major industrial countries face a far greater challenge in meeting future pension and social security obligations two decades or so hence. There is widespread concern about the size and growth of the U.S. debt, but until recently, little attention has been paid to "off the books" debts of other nations.

INVISIBLE CLOUD. These hidden debts arise from retirement obligations in countries that have rapidly aging populations. When a large cohort of the population is relatively young, more people pay into government retirement systems than withdraw funds. But when that group starts to age, cash flow eventually turns negative. Calculating the net present value of these future liabilities requires many assumptions, but it can be done. Recent estimates from the Organization for Economic Cooperation & Development show an astounding problem on the horizon for many industrialized nations.

Here are some conservative estimates: In Canada, the ratio of public debt to GDP is near 100%; net future pension liabilities amount to another 100%. Italy's already huge debt ratio is overshadowed by pension liabilities of an additional 113% of GDP. Finally, in Japan, where the debt ratio is moderate, public pensions coming due account for 110% of GDP. In the U.S., the corresponding liabilities amount to only 31% of GDP.

The problem can be traced to a number of factors. First, the active labor force that contributes taxes for future pensions will decline relative to beneficiaries. This effect will come into play between 2010 and 2030, first in Japan, where aging will occur soonest, then in Europe. The second factor is that longevity has risen around the world, but people aren't working longer years in most countries. Hence, their withdrawals from public pension accounts have risen even though their contributions have not. Declining birth rates in industrial countries are also slowing the retirement revenue stream. Last, legislatures were overly generous when the pension schemes ran surpluses over the past 30 years.

PRIVATE POOL. With future liabilities so mind-bogglingly large, some people argue that these pensions will never be paid. That's not likely to happen, though, since an aging society also means an aging electorate. So how might the obligations be met? Taxes could be raised on future generations, but tax levels are already high—and hiking taxes is unpopular and unproductive. Another possibility is to find a way to phase in later retirement. Still another option for the industrialized nations is to turn toward their less developed neighbors and borrow from them: Brazil, China, Mexico, and other countries with young populations will have high savings that could be invested in the paper of industrialized nations. Yet while such efforts might ameliorate the problem, they won't solve it.

Two things must be done. First, the accumulation of ever-growing liabilities must be contained. Second, savings in these industrialized nations must be increased sharply—not only by cutting government spending but also by raising private savings. The best way to accomplish this is via mandatory private-savings schemes, such as those in Chile and Singapore, where households must set aside a significant portion of their income for retirement and disability. But rather than paying it to the government in taxes, these savings should be placed in qualified accounts under private management. Thus, private saving is not automatically diverted to finance budget deficits.

Without a buildup in public and private savings, expect a crunch in world capital markets. Major governments will be forced to borrow huge amounts to finance pensions, and interest rates will be driven sky-high. Fortunately, there is enough time for policymakers to figure out how to avoid such a scary encounter with capital shortage.

Rudi Dornbusch is professor of economics and management at Massachusetts Institute of Technology

Finance

INVESTIGATIONS

HOW ARE YOU VOTING? WHAT ARE YOUR STOCKS?

Members of Congress often invest in companies whose fortunes they could influence

GOOD CHOICE: *Senator Bond's teenage son quadrupled his investment in McDonnell Douglas*

PHOTOGRAPH BY NAJLAH FEANNY/SABA

When the Senate Appropriations Committee announced its plan for next year's defense outlays in July, McDonnell Douglas Corp. was a big winner. Included in the blueprint was $880 million above what President Clinton has requested for another 22 jets manufactured by the St. Louis-based company. And no small thanks went to Senator Christopher S. Bond (R-Mo.), a member of the Senate subcommittee that sets defense spending and a key champion of the aerospace company's defense contracts.

Among the happy McDonnell Douglas shareholders was Sam Bond—the senator's 14-year-old son. Back in May, 1993, the younger Bond, with advice from his father, scooped up somewhere between $1,001 to $15,000 worth of McDonnell Douglas stock when it was around 20. Today it is over 80. A spokesperson for Bond says that the younger Bond has been buying stock—with advice from his father—as a learning experience. He insists that there is no conflict of interest, adding that young Sam Bond "is not privileged to any information."

Investments such as Bond's may raise eyebrows, but they are hardly unique. An extensive BUSINESS WEEK review of financial disclosure filings by members of Congress reveals that many elected officials or their relatives routinely invest in or even actively trade stocks in industries under congressional scrutiny or about which they have special knowledge. Under current law, members are only required to disclose their investments and transactions, as well as those of their immediate families, once a year. Even then, the disclosures are in broad dollar ranges. None of this activity is illegal, but critics say the current rules give members too much opportunity to profit from their positions. "The ethics rules are so vague that members can say that what they are doing is not specifically prohibited," says Michael A. Calabrese, a director of the public interest group Congress Watch.

Many members and their families take full advantage of this unfettered ability to invest. Senator Lauch Faircloth (R-N.C.), whose 1994 filing is not yet available, held more than $850,000 worth of North Carolina-based banking stocks at the end of 1993 while serving on the Senate Banking Committee. And Senator Dale Bumpers (D-Ark.) and his wife have traded stock in Arkansas meat producers Tyson Foods Inc. and Hudson Foods Inc. over the past six years. During this period, Bumpers was a member of, and eventually chaired, the subcommittee that sets spending for the Agriculture Dept., which regulates such companies.

JUST ASKING. A spokesman for Faircloth says the senator has asked the Senate Ethics Committee to determine whether his bank holdings could constitute a conflict of interest. And a spokesman for Bumpers says that because his subcommittee does not deal with issues that affect individual companies, the investments don't pose a conflict.

In some cases, members even push legislation that would directly benefit their investments. This February, Senator Don Nickles (R-Okla.) introduced a bill to create tax incentives for the domestic oil and gas industry. At the end of 1994, Nickles also held about $6,500 worth of stock in energy companies Enserch Corp. and Unocal Corp. Nickles

"They have access to all kinds of information, and they have the power to get it quickly"

says financial advisers handle his investments independently and insists his holdings don't create a conflict of interest. "If someone insinuates that I would try to impact policy for that [investment], that is offensive," he asserts.

Like Nickles, most members contend their promotion of legislation has nothing to do with their investments. Senator Harry M. Reid (D-Nev.) added to his portfolio of mining properties shortly before he co-sponsored an industry-supported mining reform bill in 1993. A spokesperson denies a conflict of interest. Senator Frank H. Murkowski (R-Alaska) is under fire from environmental groups who say a bill he recently introduced would benefit Louisiana-Pacific Corp., a company in which he and his wife hold stock. Murkowski could not be reached for comment.

Sometimes members throw their weight around in other ways that appear to benefit their investment portfolio. In May, Representative Dave Camp (R-Mich.), along with nine other lawmakers, sent a letter to the head of the Food & Drug Administration asking the agency to publicize the results of several studies that found no link between silicone breast implants and connective-tissue diseases. Camp's 1994 filing shows at yearend he was holding more than $500,000 in stock in Dow Chemical Co., 50% owner of breast implant maker Dow Corning Corp. Based in Midland, Mich., in Camp's district, Dow Chemical is facing many lawsuits in connection with the implants. While Congress Watch's Calabrese contends the action may have constituted a violation of ethics rules, a spokesperson disagrees and says the letter had nothing to do with the congressman's investment.

TOUGH RULES. Lawmakers bristle at the notion that they might be using their positions for profit. But employees of the executive branch are under strict conflict rules. Government agency appointees and workers are not permitted to work on matters that could affect their personal financial interests. And many departments have additional restrictions. For example, employees of the U. S. Geological Survey can't invest in companies that lease land administered by the agency.

Congressional ethics rules place virtually no restrictions on investments by members. They require members to disclose their investments and transactions every year. The only strict prohibition bars members from voting on or pushing legislation that benefits a very small group that includes themselves. But if the bill benefits them as members of a larger group—as shareholders, for example—they face no restrictions.

In many cases, members trade in stocks just as those companies are coming under fire in Congress. Information about possible or pending legislation is often well known, making it unlikely that trading based on that information would constitute a violation of insider-trading laws. Still, critics charge that members can use their firsthand knowledge of bills percolating on the Hill to their advantage. "They have access to all kinds of information, and they have the power to get it quickly," says Alex Benes, managing director of the Center for Public Integrity, a watchdog group.

Tobacco stocks are a good example. Gregory W. Boller, a marketing professor at the University of Memphis who has examined congressional stock trad-

Pushing the Ethics Envelope?

Some recent questionable investments by members of Congress. All deny these constitute a conflict of interest.

SEN. FRANK MURKOWSKI (R-Alaska)

INVESTMENT At the end of 1994, Murkowski and his wife held between $15,001 and $50,000 in Louisiana-Pacific Corp. stock.

POSSIBLE CONFLICT On July 21, Murkowski introduced a bill that could spur logging in the Tongass National Forest, where a Louisiana-Pacific subsidiary is one of the largest operators.

SEN. HARRY REID (D-Nev.)

INVESTMENT In April of 1993, Reid paid between $50,001 and $100,000 for an added interest in 57 acres of mining property.

POSSIBLE CONFLICT The following May, Reid co-sponsored a mining reform bill that would have imposed a modest royalty on miners. The move was backed by the industry over more severe proposals.

REP. DAVE CAMP (R-Mich.)

INVESTMENT At the end of 1994, Rep. Camp held between $500,001 and $1,000,000 in Dow Chemical, which has been sued over silicone breast implants.

POSSIBLE CONFLICT Camp signed a letter asking the FDA to publicize research showing no connection between implants and certain diseases.

SEN. DON NICKLES (R-Okla.)

INVESTMENT At the end of last year, Nickles held more than $6,500 in stocks in oil and gas companies Enserch and Unocal.

POSSIBLE CONFLICT In February of this year, Nickles introduced a bill to provide tax incentives to the domestic oil and gas industry and to ease regulatory burdens.

DATA: BUSINESS WEEK

(CLOCKWISE FROM TOP LEFT) PHOTOGRAPHS BY GAMMA-LIAISON; ERIK FREELAND/MATRIX; ROBERT TRIPPETT/SIPA; AP/WIDE WORLD

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Vista *Investors*	55.4%	12.5%	16.1%	13.5% (11/25/83)	14.6% (11/25/83)
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Select *Investors*	16.5%	7.4%	12.3%	16.6% (6/30/71)	11.7% (6/30/71)
Growth *Investors*	22.7%	11.2%	15.5%	18.5% (6/30/71)	11.7% (6/30/71)
Heritage *Investors*	19.7%	11.4%	–	16.0% (11/10/87)	15.0% (11/10/87)
S&P 500 *Index*	26.0%	12.1%	14.6%	–	–

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ing, says 16 members traded in either Philip Morris Cos. or RJR Nabisco Inc. stock in 1993 as the antitobacco mood in Washington began to heat up. The majority of those trades were sales. Representative Henry Bonilla (R-Tex.) liquidated a $1,001 to $15,000 holding in Philip Morris as House colleague Representative Henry A. Waxman (D-Calif.) was trying to drum up support for a bill restricting smoking in public buildings. Bonilla's office says his investments are made by an outside adviser.

Some lawmakers think it's time to stop congressional stock trading. In March, members of the House Progressive Caucus introduced legislation that would require members of Congress to put personal investments into a blind trust. In a blind trust, the client never sees how the money is invested. Congress, however, is unlikely to impose such restrictions. Some members argue that the annual cost of a blind trust, often at least 1% of the assets, makes it too expensive for members of modest wealth. Others warn that members can suffer large losses if they have no control over their assets. Bond is suing PaineWebber Inc. and a former adviser for more than $1 million over losses he suffered in a blind trust he held until early 1993. PaineWebber declined comment on the suit. "Am I supposed to say because I'm in public service I'm going to turn everything I've worked for over to some person in a brokerage office? Baloney," argues Representative Dan Burton (R-Ind.) who manages his own $145,000 portfolio.

SIDESTEP. Still, lawmakers are under pressure to voluntarily restrict their trading. Representative Thomas J. Bliley Jr. (R-Va.) announced in June that he would put his more than $490,000 in assets into a blind trust. The move came after questions had been raised about potential conflicts of interest created by Bliley's chairmanship of the powerful House Commerce Committee. And some members, such as Representative Bill H. Zeliff Jr. (R-N. H.), who sold more than $25,000 in stocks when he was elected in 1990, avoid the issue altogether. "People will be looking for things where you appear to be taking advantage of your office," Zeliff says. "You are smart to avoid that."

But Zeliff is clearly in the minority. For now, members appear more than happy to deal with the nagging questions posed by their investments in exchange for unrestricted ability to play the market. Unless that changes, they'll continue pushing—right to the edge.

By Amy Barrett in Washington

WSJ 8/11/95 p. B1 + B2

Study Now, Pay Later: Students Pile On Debt

By ELLEN GRAHAM
Staff Reporter of THE WALL STREET JOURNAL

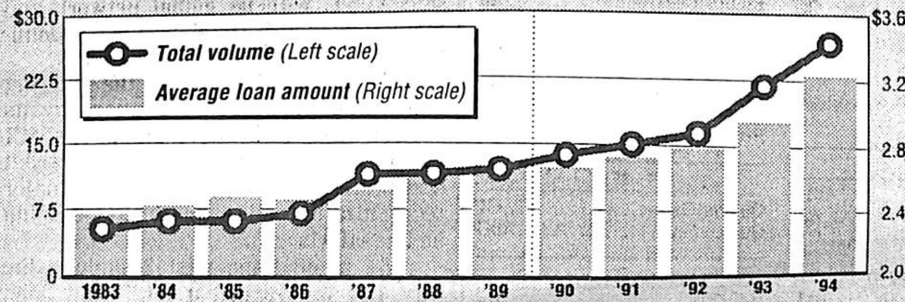
From the Ivy League to state universities, college students are studying now and paying later, often incurring loans the size of mortgages by the time they finish graduate school.

Joseph Pearson, a 41-year-old who has earned three master's degrees, is now in the sixth and final year of a Ph.D. program in philosophy at Northwestern University. He teaches three college classes but has to fill the gap between his pay and tuition costs with student loans. "When I get my Ph.D. in December, I'll be $60,000 in debt," he says, but "with no career to speak of, facing a terrible job market."

While extreme, his situation is by no means an anomaly. "The numbers are just astonishing," says Leila Edwards, senior associate dean of Northwestern's graduate school. She knows of a Ph.D. candidate in English who has borrowed $90,000, and a student working on a master's in hearing therapy who owes $50,000. Repaying even $50,000 at 8% over 10 years comes to $644 a month – too onerous, she fears, for students starting out in low-paying fields.

Student-loan volume exploded after 1992, when Congress tried to take some sting out of college tuition inflation by opening up federal loan programs to more middle-class families. Over a million new borrowers came in during the first year. Between 1992 and 1994, the American Council on Education says borrowing under federal student-loan programs rose $8.4 billion, or 57%, to $23.1 billion. Of the $183 billion lent since the program's inception in 1966, 22% came in the past two years.

EDUCATION



What has happened is a fundamental shift in the way higher education is financed in this country. "In the past," says Patrick Callan, executive director of the California Higher Education Policy Center in San Jose, "every generation took on most of the responsibility for educating the next. Now the young are paying for it themselves, out of future earnings."

The days when students could cover tuition bills with summer jobs are over. Meanwhile, government grant money has been drying up in favor of loans. And as state aid to education has dwindled, tuition increases at public universities have hit double digits. Eye-popping Ivy League tuitions may make headlines, but they affect relatively few; 80% of U.S. students attend public institutions, where annual costs at a four-year university now average $6,862.

The social toll: Educational debt steers students away from low-paying careers such as teaching and deters them from seeking advanced degrees. "It has an insidious effect on aspirations," says Terry Hartle, vice president of governmental relations at the American Council.

Whether students are actually borrowing too much won't be known for some time because that depends on their future incomes. A $20,000 loan might be excessive for a future Head Start teacher but not for a future computer scientist. Yet even medical-school graduates—who often begin residencies owing $100,000 – face dicier income prospects now than five or 10 years ago.

Sheri Springs-Phillips has run up $102,000 in debt in her journey from the South Side of Chicago to a second-year neurology residency at Loyola University Medical Center in Maywood, Ill. She works 80-hour weeks and worries about $2,500-a-month loan payments that will start coming due once she finishes her residency next year. Friends tell her, "Girl, you're going to be living large." But she sees no Lexus or five-bedroom home in her future.

At age 27, she has lived through 11 years of indebtedness and figures it will be a decade or more before her loans are paid off. By then, her 15-month-old daughter will be nearing her teens, and she wonders: "Where does her educational fund come from?"

Even families that salted away funds for undergraduate school often failed to anticipate how critical an advanced degree would be to landing a career-track job in

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Students Increasingly Pile On Debt

Continued From Page B1

today's economy. So most students are on their own when it comes to paying, say, bills of $35,000 a year for private law school.

"The boomer generation didn't manage money very well," says Ruth Lammert-Reeves, assistant dean for financial aid at Georgetown University Law Center in Washington. "They all figured they were making more money than their parents and didn't save."

She's encountering students who have charged some of their undergraduate tuition on credit cards. Her loan officers nag students not to borrow more than necessary, "but it's swimming upstream to get them to delay gratification," she says.

And many 18- and 19-year-old borrowers are naive about their obligations. According to a recent paper by the American Council's Mr. Hartle and Fred J. Galloway, student-loan counselors are often asked: "You mean I have to pay interest on my student loan?"

Graduate students will face even more grief if, as is possible, Congress eliminates interest exemptions on their student loans. Currently, the government pays the interest while they are in school; cutting that subsidy would drive up the cost of borrowing sharply. While some students can stretch out repayments for 25 years, that, too, vastly increases the cost of the loan.

Mariabeth Silkey, a doctoral student in quantitative ecology at the University of Washington, already owes $30,000 and needs to borrow another $5,000 for each of her remaining four years of school. Without the interest exemption, she calculates that by the time she earns her Ph.D. she'll owe $27,000 more, including $7,000 in accrued interest. Repayment will cost her $700 a month for 10 years, twice her current monthly rent.

But Ms. Silkey sees little alternative. She's already working 40 hours a week—as a research assistant, German translator and manager of her apartment building. She aspires to "interesting, useful" work improving water quality. But with jobs in the public sector starting at about $35,000, she doubts she'll ever recoup her educational investment.

For others, relief is sometimes available. Georgetown Law offers loan-repayment assistance to graduates pursuing public-service careers. To give students time for research and to encourage them to enter teaching, Stanford University's School of Medicine lets them stretch medical school over five years and knocks off all but 10% of the final year's tuition.

By agreeing to work at a National Health Service Corps clinic in rural Washington state, Lucila Martinez of San Antonio hopes to discharge part of the $130,000 she borrowed for dental school. For every year the divorced 40-year-old works at the clinic, $25,000 of her loan will be forgiven. Her plans still could go awry, though: Congress has identified the corps as a possible target for budget cuts.

Mexico Isn't Letting Go of Bad Loans

U.S. Firms Aiming to Buy Sour Debt at a Discount Find Barriers, Not Deals

By CRAIG TORRES
Staff Reporter of THE WALL STREET JOURNAL

MEXICO CITY—It's been a bad year for anybody who expected to make a killing by buying distressed Mexican debt.

With Mexico in a full-blown economic crisis, set off by a peso devaluation Dec. 20, a number of bankruptcy, or "vulture," funds have been hastily put together to take advantage of what was supposed to be a big sale of troubled Mexican credits. These specialized investors expected to find lots of banks willing to dump bad loans at deep discounts and companies willing to swap suffocating debt for equity.

What the funds found instead was a brick wall of cultural and regulatory obstacles that won't allow a secondary market for bad loans or distressed assets to develop. So, despite historic levels of bad debts in Mexico, most of the U.S. bankruptcy players working here can't point to a successful deal so far.

Banks "don't seem motivated to trade or work out of [bad] assets," says Andrew Oksner, managing director at **Libra Investments Inc.** in Los Angeles, which has raised some $200 million for Latin America vulture investing. "Deals are not getting done."

Others say the lack of deals could create problems over the long term by limiting the capital available to the fragile Mexican banking sector.

Typically, vulture funds buy packages of past-due loans at big discounts. They, then go to the debtors, renegotiate terms and hope to get paid as much as 100 cents on the dollar, plus interest, on loans they bought for as little as 30 cents on the dollar. In other cases, bankruptcy funds will buy bonds or loans of troubled companies and try to swap the debt for equity. The funds are unpopular with business owners and bankers, who feel the funds are essentially charging high prices for life jackets, but the funds can provide a valuable service by injecting capital into banks and businesses that have nowhere else to turn.

In Mexico, however, banks haven't felt the need to turn to fund managers because the government has so far stepped up as a buyer of last resort. The government has now absorbed four banks, an insurance company, a smattering of credit unions and $1.4 billion in loans it recently bought from two banks.

"It is definitely a 'no-fail' policy," says one executive working inside a government-controlled bank, who added that the government has shown no desire to sell off the bad assets in these state-owned banks.

The funds have also had little success approaching individual companies because Mexicans value their businesses, which are typically family-owned, using principles other than cash flow, which is the main tool of the bankruptcy players.

Abelardo Morales Puron, chief executive officer of **Grupo Financiero Serfin** SA, holding company for Mexico's third-largest bank, says that "banks lack the right legislation" to sell assets. "It is a shame we aren't taking advantage of these" specialized bankruptcy funds to find new capital for the hard-pressed banking system, he says.

For one thing, laws generally say that banks can sell credits only to other banks. In addition, Mexican accounting requires a bank to set aside more reserves for a loan if the bank decides its chances of being repaid have diminished and assigns the loan a lower rating. That provision gives banks an incentive to rate loans as high as possible.

But a loan sale immediately assigns a market value to loans, not just that single loan but all loans like it at all banks, and that amount is much lower than the value banks list them at today, bankruptcy investors say. So, if government-controlled **Banco Union SA** sold the loans it has outstanding to a local builder, then chances are the sale would create a cascade of loan markdowns across other banks. The markdowns would require higher reserves and cut into banks' capital, reducing their already limited ability to lend.

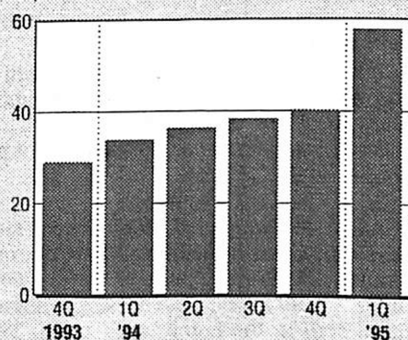
"The act of selling these assets forces you to own up to the truth, or 'mark to market,' which is something a lot of [banks] don't want to do," says John Detmold, chief executive of **Banca Quadrum** SA, a Mexican bank.

Mr. Oksner, the fund manager, says: "There is no strong attitude in Mexico that this is the time to fix" bank portfolios through asset sales. "But very frankly, this sets the stage for a deferral of problems."

Even if the government decided to prime the market through some loan sales, bankruptcy investors would find additional obstacles. Buying just a slice of a company's total loans is risky, for example, because the oldest loans are the most senior creditors. To protect against the pitfalls of being a junior creditor to a company, bankruptcy funds must try to buy all of a company's loans, a process that could be complicated because it would involve many banks.

So, even though vulture investors have been active in the real-estate market here, few are likely to accomplish much in the debt market for some time.

"I don't think we will see a secondary market for these assets until we have adequate legislation to simplify the process," says Rafael Moreno Valle, partner at Elek, Moreno Valle & Associados, an investment bank here.



Not for Sale
Mexican banks' gross past-due loans, in billions of pesos*

*Doesn't include past-due loans of the following government-intervened banks: Banpais, Banca Cremi, Banco Union, Banco de Oriente. Also excludes Multibanco Mercantil Probursa, a private bank that recently passed through a government-assisted restructuring.
Source: Salomon Brothers

WSJ 8/9/95 p. A10

Working Poor Fear Welfare Cutbacks Aimed At the Idle Will Inevitably Strike Them, Too

By DANA MILBANK
Staff Reporter of THE WALL STREET JOURNAL

From their A-frame home in South Dakota, Nancy and Ted Lewis are anxiously following the Senate debate over welfare overhaul.

It wouldn't seem to be necessary. The Senate, which yesterday put off action on the issue until next month, is fussing about single teenage mothers producing oodles of illegitimate children; the Lewises are married, in their late 30s, with two kids. The lawmakers are attacking those who would rather collect a check than get a job; Mr. Lewis not only has a job – he has three of them.

Yet for all his labors, Mr. Lewis's family relies on welfare – food stamps, Medicaid, housing subsidies and tax credits – to supplement his annual income of $12,000. And as Congress scales back these benefits in the welfare bill and other legislation planned for this year, it risks hitting millions of working-poor families along with the welfare abusers it intends to target.

"There are people who don't fit the stereotype, who are working, who are trying to make it and who still can't make ends meet," Mrs. Lewis says. "This benefit is helping working families, and they're trying to cut it out."

The Working Poor

- **56%** of people in poverty are in working-poor households.
- **100%** of those receiving Earned Income Tax Credit are from low-income households (not all are working poor).
- **20%** of food-stamp recipients are from working-poor households.
- **43%** of children on Medicaid are from working-poor families.

Source: Center on Budget and Policy Priorities.

The Lewises may not be stereotypical welfare recipients, but they are in many ways typical. There are some 22 million Americans in working-poor families, according to the Washington-based Center on Budget and Policy Priorities, or more than half of all poor people. Politicians on both sides have made little distinction between welfare freeloaders and those already working, a blurring that could mar a goal – welfare overhaul – that has wide public support. "We begin united in the knowledge that our current welfare system is broke," Senate Majority Leader Robert Dole of Kansas said in launching this week's aborted Senate debate.

In particular, the main welfare program, Aid to Families with Dependent Children, is widely viewed as a spectacular failure. But despite its prominence in the debate, AFDC amounts to about only 25% of income-support spending and not much more than 5% of spending on means-tested assistance. As Congress moves on its overhaul of this and related programs, it is including similar changes for child care, food stamps and child nutrition – programs that benefit a greater percentage of working people. Also planned for this year are cuts in the Earned Income Tax Credit and Medicaid that would more directly affect the working poor.

'Doing What They Can'

"The only picture in the welfare debate this year is of poor people sitting around collecting checks," says Isaac Shapiro, who studies the working poor at the Washington-based Center on Budget and Policy Priorities. "There isn't much discussion of the sweeping implications for the working poor. Not only do you end up with welfare reform, you also are cutting low-income programs for those who are already doing what they can."

Proponents of the legislation argue that the impact on the working poor will be minimal. In the end, "I don't think they'll be worse off," says Sen. Rick Santorum, a Pennsylvania Republican who is co-sponsoring Sen. Dole's welfare bill. The Senate is tempering some of the House provisions that would have affected the working poor most directly, Sen. Santorum says. The Senate bill is likely to have stronger child-care and child-nutrition provisions, and it makes fewer changes to the food-stamp program.

Currently, the feeling of the working poor "that they're doing their part and not doing better than someone bilking the system really creates a lot of anger," Sen. Santorum says. The effect of the changes "on the working poor is to know that people who are not working are going to be expected to pull their share of the load."

Even some conservatives, however, are uneasy about the effects some of the proposed changes will have on the working poor. The Heritage Foundation's Robert Rector, an adviser to conservatives on welfare, says another Senate plan to cut the Earned Income Tax Credit, a benefit that targets only the working poor, is "almost inexplicable." The EITC, which has until now had bipartisan support, would be cut by $21 billion over seven years under a budget resolution; that would reduce fraud and errors, proponents say.

Bid to Offset Damage

Republican lawmakers hope to offset the damage to low-income workers with its proposed $500-a-child tax credit, which like the EITC is in legislation other than the welfare bill. But this credit won't do much for those in or near poverty who pay little or no income tax.

The result would be a pinch for those hovering near poverty. Karen Olson and her husband, Paul Lovestrand, for example, have an annual income of $22,500; he works full-time in a bakery and she works part-time in addition to caring for their three children. Ms. Olson figures they'll lose most of the $541 tax credit they received last year if the EITC is cut, but their income is too low for the Dependent Care Tax Credit to make much difference. Ms. Olson also worries that Medicaid benefits for her three children will shrink. That's no small worry, with debts and mortgage payments to make on their $43,000 house.

"When people talk of people on welfare they don't think of people like my family," Ms. Olson says. "The gap between rich and poor is getting wider, and it's getting harder for people like us to get into an income bracket where we're self-sufficient."

These are bad times for low-income workers, regardless of what happens in

Washington. Technology and competition are driving down wages for the least-skilled; high-school dropouts saw inflation-adjusted wages drop 22.5% between 1979 and 1993, according to Rebecca Blank, a Northwestern University poverty specialist. "When you put these wage changes on top of substantial cuts in assistance, you wind up aggravating income problems for low-income families," she says.

In addition to the tax credits, according to the Center on Budget and Policy Priorities, a congressional budget resolution plan to reduce Medicaid by $182 billion over seven years would hit the working poor, because 43% of children on Medicaid are from working-poor families. Similarly, the center says the bill passed by the House would reduce overall child-care funding by 15% in the year 2000 in real terms and cut food stamps by 30% by 2005. Funding for child nutrition would also be cut, by $6.9 billion over five years.

Much depends on what the states decide to do. But the proposed changes could have some unintended consequences for working people. One of them is Kyle Estrada, a 34-year-old single mother of three from Green Valley, Nev. She makes $12,000 a year working for Head Start but has another 18 months until she earns her bachelor's degree so she can become a teacher. In the meantime, she's relying on $262 a month in food stamps and a tax credit of $1,500 a year.

If those programs are cut, Ms. Estrada thinks she could get a second job, but that would jeopardize her degree – and with it, hopes of leaving public assistance altogether. "I can't give up on my school, that's my ultimate way out," says Ms. Estrada, who says she has a 4.0 grade-point average.

Like others who are working and poor, Ms. Estrada resents being grouped with the idle. She's all for overhauling welfare, but adds: "They've got to give working people an alternative."

Economic Scene | Peter Passell

Despite some problems, the news from Mexico is mostly good.

REMEMBER the peso crisis in Mexico? No news, in this case, is largely good news. The much criticized "bailout" has allowed the Government to avoid default on its debts and even begin attracting foreign capital. "The White House should get high points" for preventing panic and helping to minimize the pain that followed the devaluation, concludes Jeffrey Sachs, director of Harvard's Institute for International Development.

But there is still plenty to worry about. For while Mexico's deep recession, engineered to permit exports to regain their competitiveness in world markets, has reshaped the economy faster than expected, Mexico's capacity to achieve Asian-style growth remains very much in doubt. "Financial stability," suggests Rudi Dornbusch, an economist at M.I.T., "has been given the upper hand over a sustainable development strategy."

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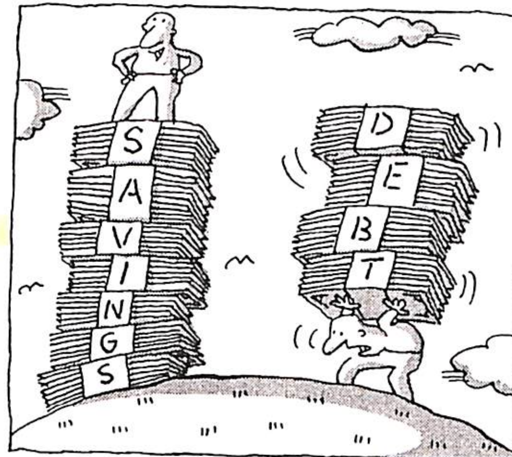
Mexico's devaluation was virtually inevitable because the administration of former President Carlos Salinas de Gortari allowed the peso to rise sharply in the 1990's relative to its purchasing power. Inexpensive imports, the reasoning went, would keep Mexican consumers happy and force long-protected Mexican industry to shape up or shut down.

But once foreigners got the message that Mexican exports were uncompetitive, the torrent of foreign investment that had sustained the overvalued peso stopped and Mexico could no longer pay its bills with borrowed dollars.

Unfortunately, the Government delayed the day of reckoning until after national elections by spending down its nest egg of foreign currency. Thus, when devaluation did come, those who had lent dollars to the Government quite reasonably worried that Mexico would be forced to renege. The "bailout," in the form of a $51 billion line of credit collateralized by Mexico's revenue from oil exports, prevented investor panic and the Government's default.



Niculae Asciu

Lawrence Krohn, a senior economist for the Union Bank of Switzerland, argues that President Ernesto Zedillo then gambled that harsh belt-tightening would permit Mexico to put its financial mistakes behind it in a hurry. And thus far, the gamble seems to have paid off. Populist politicians have not been able to make inroads by promising an end the austerity. Indeed, Mr. Krohn says, "the left has gained no ground."

Foreign investors, particularly direct investors in no rush to recoup dividends, are coming back. What is more, the overnight reduction in domestic spending has permitted exporters to divert billions of dollars of Mexican goods into world markets, transforming an $18.5 billion trade deficit in 1994 into a surplus estimated at $5.5 billion this year.

This turnaround is far faster than conventional economics would predict. But it does not surprise Fred Bergsten, director of the Institute for International Economics. "Mexican industry has a tradition of looking abroad for markets when domestic demand is slack," he notes.

With any luck, Mexico's recession will end this year after a drop in economic output of between 3 percent and 4 percent. The Union Bank of Switzerland is forecasting 2 percent growth in 1996. And Mr. Krohn believes that Mexico is capable of achieving sustainable growth of 4 percent.

But don't crack that bottle of tequila just yet. For one thing, Mr. Dornbusch notes, déjà vu could happen all over again. Once the economy is out of recession and foreign investors return in force, Mexico may well be tempted to let the peso creep back up to an exchange rate that inhibits export-led growth.

Besides, 4 percent growth (partly offset by 2 percent population growth) would hardly put Mexico in the big leagues with, say, Thailand or even Chile. Mexico and Chile, incidentally, had virtually the same per-capita income in 1986; this year, Chile's will be 80 percent higher.

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The heart of the problem, Mr. Dornbusch argues, is Mexico's failure to save enough to finance its own growth. According to the International Monetary Fund, Mexico's savings have averaged just 14 percent of income in the last decade, compared with an average of 20 percent in countries at a similar stage of development. And because Mexico cannot rely on foreigners to make up the difference, growth is ultimately constrained by the willingness of affluent Mexicans to put more in the bank and less in their cars and houses.

Mr. Dornbusch says that institutions are to blame, not the culture. "Mexico does suffer from proximity to the United States," the world's most profligate economy, he jokes. Nonetheless, he argues, public policy could make a big difference.

Mr. Dornbusch has in mind higher taxes that would allow the Government to run a permanent budget surplus. And he would like to see a Chilean-style system of forced savings for retirement, in which a portion of everyone's wages is assigned to the private mutual fund of the saver's choice.

The Zedillo administration has, in fact, acknowledged the savings problem. But with Mexico's decaying ruling party divided on how much and how fast it dares change, serious reform is no certainty.

Orange County's recov
took another blow yesterda
Pete Wilson of California
bill that would have prov
county with new revenue
pay its huge debts.

The measure, which ha
both chambers of the
Legislature last week, wo
allowed the county to shif
lion a year in funds earm
transportion to cover its ba
related debts, which now
billion.

But Orange County's
have become intertwined
of neighboring Los Angel
and that connection is
Governor Wilson's veto.
ure would have allow

Containing China

IN POLITE society, the words containment and China are not to be uttered in the same breath. "Our policy is engagement, not containment," asserts Winston Lord, America's assistant secretary of state for East Asia. "If you treat China as an enemy, China will become an enemy," says Joseph Nye, his colleague at the Defence Department. But as China tests missiles off the coast of Taiwan and speaks of possible invasion (see page 23), it is becoming harder to pretend that it is not, potentially, a source of huge instability. Western and Asian countries need to recognise this. It is right to try to engage China, but it is also right to make it much plainer that China has no licence to threaten its neighbours. The two policies are not antithetical. Economic engagement and strategic containment should be part of a coherent whole.

The present crisis over Taiwan may blow over. But look ten or 20 years ahead and it is easy to see grounds for anxiety. Almost one in four people in the world is a citizen of China. Over the past 15 years China has had the world's fastest growing economy. Simple *Realpolitik* suggests that a huge, increasingly prosperous country is likely to want to throw its weight around. Big countries are likely to be difficult to live with if they have a strong sense of cultural superiority, or if they have historical grievances about their treatment by the rest of the world. China has its share of both chauvinism and grievance.

Spooked by the prospect of a more prosperous and assertive China, outsiders can be tempted into one of two mistaken policies. The first is to pray for China to break up, as the Soviet Union did. Many Chinese already suspect that this is the real aim of the West. But the hope that China will fall apart is a dangerous illusion. China is much more ethnically homogeneous than the Soviet Union ever was. And even if it were not, a China riven by civil war would be a humanitarian disaster that would send dangerous shock waves throughout Asia.

The second mistake is to see the West as the central source of tension, either because it complains about China's disdain for human rights or because it sometimes seems to treat Taiwan as though it were a fully independent country. It is true that American, and indeed Asian, policies towards China could be better thought out. But the real source of the current tension is China, whose actions over Taiwan have grown more strident just as its threats in the South China Sea have grown more belligerent. The Chinese insist that they have never been an expansionist power, yet the presumptuousness of their border claims does nothing to reassure their neighbours. Since weak Chinese governments have always been especially prickly on issues of "sovereignty", instability after the death of Deng Xiaoping may only heighten Chinese assertiveness.

The outside world can do little to influence what goes on within China. But in foreign affairs, China will respond to the signals sent by other countries. Unfortunately, particularly during the Clinton presidency, those signals have become confused. Under Mr Clinton, the Americans have sometimes given the impression that, after the cold war, economics—by which America seems to mean little more than export promotion—is all that matters. Strategic concerns about the balance of power in Asia now seem to be regarded as anachronistic. In fact any attempt to deal with growing Chinese power must combine economic openness with strategic firmness.

Economic growth and liberalisation represent the best chance of making China easier to live with, both by creating internal pressures for more political freedom and by strengthening China's interest in getting on with the rest of the world. That means encouraging trade and investment, and seeking to involve China in bodies such as the World Trade Organisation, while rejecting Chinese demands for special concessions. It also means resisting protectionism in the West, even when this is linked to concerns about human rights. If the West wants to apply pressure in pursuit of human rights, it has political weapons to use, such as denying China the prestige associated with holding international events like the Olympics.

Trade easy, hang tough

Yet economic engagement alone will not persuade China to stop threatening its neighbours. The reluctance of western policy-makers like Mr Lord to use the word containment, with all its cold-war connotations, is understandable. Containment should not mean ringing China with nuclear weapons, as the West did the Soviet Union. But it should mean recognising that China is a destabilising force and impressing upon it the need to forswear force in trying to settle its grievances.

Such a policy can work only if western and Asian countries work together. America should not let its obsession with its trade imbalance with Japan rupture a crucial alliance. South-East Asian countries should stop averting their eyes from reality and instead make a more active effort to keep an American military presence in the region. It is unlikely that China would have challenged the Philippines over the rocky islet it claims in the South China Sea if the American navy had still had its Philippine base. Lastly, western countries must present a united front. Some Europeans have been all too willing to take advantage of a Chinese row with America to win Chinese contracts. The Europeans should realise that hiding behind American skirts on issues like Taiwan, the South China Sea and even human rights, whatever the short-term commercial advantages, is not in their long-term interests.

No policy can guarantee good behaviour by the Chinese. If

events in Taiwan appear to be leading towards a declaration of independence, China may invade. But the best way to minimise this possibility is not to appease China by cutting Taiwan off from international society. That would be to concede China's basic contention that whatever happens between China and Taiwan is an internal Chinese affair, and thus to concede its justification for an invasion of its island neighbour. Encouraging the Taiwanese to declare independence would be irresponsible, since there is no prospect of the West being willing to fight a war for Taiwan. The best policy is gradually to expand ties with Taiwan, as America is already doing. China should be left in no doubt that an invasion of Taiwan—the United States' sixth-largest trading partner—would comprehensively wreck relations with capitalist Asia and the West, far more than the killings of pro-democracy demonstrations in Beijing in 1989 ever did.

No Chinese government can contemplate such a prospect lightly. China hopes that the next century will bring it more power and more respect. But it also knows that continued economic growth is critical to that ambition. The only serious threats to rising prosperity in China are internal collapse or war, so China will not start a war unless it believes it could do so without bringing intolerable economic disruption. If the Chinese entertain such an illusion, they should be disabused.

Murayama's defeat

Everyone in Japan, except the government, seems to agree that the country needs an early general election. But it is not quite that simple

THESE days, when countries feel down in the dumps, it is not long before pundits start to call for two familiar medicines. The first is leadership, something there is invariably too little of, especially if the country's leader is John Major or Bill Clinton. The other, increasingly popular, pick-me-up is a general election, even if the rules do not require one to be held for several years. Calls for early polls can be heard in Spain, where Felipe Gonzalez's Socialist government is under attack, and Italy, where politics is so confusing and confused that even after June's 12 referendum votes there is still a taste for another unscheduled trip to the voting booths. Now, this view has also taken hold in Japan, following the drubbing given to the prime minister's socialist party in elections on July 23rd for parliament's upper house (see page 25). Political weakness, it is thought, is helping to keep Japan's economy in recession; a dose of the polls is just what is needed to clear the blockage.

In Japan, the consensus in favour of an autumn election is remarkable: all the main national newspapers have called for one. It is true that Japan is in the midst of a political realignment that began in 1993 when the Liberal Democratic Party (LDP) was thrown out of government for the first time in almost 40 years; it is hard for realignments to occur without elections. And it is plausible to argue that if an early election could have a magical effect anywhere then Japan would seem a prime candidate, for it has severe economic problems to which the government's response has been feeble. But it is also worth sounding some cautionary notes. The call for early polls is not as consensual as it seems; it implies a hasty reading of the upper-house election results; and it may well involve a hefty slug of wishful thinking.

Divided they stand

As is often the case, the unity of view conceals a disunity of motive. Some of those arguing for a general election in Japan are doing so because they think weak government is causing economic harm. They favour more government borrowing, a more expansionary monetary policy and more use of public money to bail out troubled banks; and they think the present governing coalition, an unwieldy combination of one left-wing party with two conservative ones, is too weak to achieve that. But others who are arguing for a trip to the polling booths think that government is too strong, not too weak: they believe that bureaucratic interference, excessive regulation and cosy relationships with pressure groups are doing economic harm, and they want the chance to elect a new government dedicated to deregulation.

These views are not necessarily contradictory. You can be in favour of deregulation at the same time as believing that the government should be doing more in fiscal and monetary policy. But the two views need not go together, and in Japan they often do not. Some think government is the problem, not the solution; others still think, in the traditional post-war Japanese way, that strong government is always the best sort. Such a difference of opinion is entirely healthy. But this argument is still in its early stages, and is not fully established as a new dividing line between the main political parties.

The upper-house elections confirm this, if the results are studied carefully. Superficially, the polls were clear: a big defeat for the prime minister, Tomiichi Murayama, and his socialist party; big gains for the main opposition group, the New Frontier Party, which (more or less) favours deregulation. Yet the biggest party in the governing coalition, the LDP, which (as far as one can tell) opposes most deregulation, also did well, albeit not as well as it boasted that it would. And the most striking figure of all was the low turnout: less than half of those eligible to vote bothered to do so, making this Japan's most apathetic parliamentary election in half a century. If voters wanted to slap the government in the face and strengthen the opposition, they chose a funny way of doing it.

It would be wrong, then, to assume that an early general election would bring a new government with a clear mandate, and that such a government would then bring on the other pick-me-up, leadership. The only budding clarifier, after all, is far from clear itself. The New Frontier Party is neither new (being made up mainly of long-time political hacks); nor is it at any frontier (being still muddled about deregulation); and its fractiousness makes it barely yet a party. Japanese voters remain unimpressed by the choices on offer. Realignment is under way, but it could take several elections before clarity is achieved, not just one. Japan can have an election, by all means. But it should not expect too much of it.

NYT 8/2/95 p. A18

The Billion-Dollar Lemon

Back in June the House of Representatives voted to order two more B-2 Stealth bombers, at more than $1 billion apiece, besides the 20 already in production or completed. The Pentagon said it did not need them. Since then the General Accounting Office has issued a draft report saying the B-2 is not nearly as stealthy as advertised and has radar that cannot distinguish a rain cloud from a mountainside.

John Kasich, the House Budget Committee chairman, and Ron Dellums, Democrat of California, are again co-sponsoring an amendment to revoke the $493 million the House approved as a down payment on the two additional B-2's. The vote on their approval was 219 to 203, with 73 Democrats joining 146 Republicans. That was before the G.A.O. report. Perhaps some of those big spenders would like to think again.

The original purpose of the B-2, to penetrate Sov[illegible]t radar defenses and deliver a nuclear bomb, is now outdated. The B-2's supporters say the bat-winged bomber can also deliver conventional weapons over long distances. But that does not make it any more reliable. The G.A.O. report said the bomber might require six more years of testing. "This is a flying computer with the temperament of a sports car," a senior Pentagon official said last month.

Of the original 20 B-2's approved by Congress, six have been completed and are judged to be flyable. But even these need further testing. The 14 others, which are already paid for, will be ready by the year 2000.

In a time of excruciatingly tight budgets, this sort of careless waste should have been abandoned long ago. Members of the House will mock common sense — and their many constituents who have had to sacrifice jobs and government benefits to satisfy the budget-cutters — if they approve two more of these expensive military toys.

NYT p. A15 8/1/95

Block Grants Will Worsen Poverty

By Fred Kammer

ALEXANDRIA, Va.

If a senator proposed that the Government make no-strings grants to low-income families in place of welfare, housing, food stamps and social services, certain Republicans would lambaste him for promoting irresponsible dependency and "bad charity."

But yesterday when Bob Dole, the Senate majority leader, proposed at the National Governors' Association that the Government make no-strings block grants to states instead of financing Aid to Families with Dependent Children and some child care services, among other programs, he was praised by many Republican governors as a champion of effective government and ending welfare as we know it.

If this or any number of other block-grant arrangements eventually carry the day, what will happen to the needy people for whom many Federal programs have held off hunger, sickness and homelessness? The answer points up the intellectual and moral bankruptcy of block grants.

The block grants will lead to a system of "spiraling parsimony," in the words of an Urban Institute study, in which benefits and eligibility will be steadily cut in coming years.

Equally frightening is a second stage of this revolution: the states can turn around and drop the dwindling block grants and their heavy social burdens onto county and local governments.

State governors are hungry for billions of Federal dollars that come with no restrictions and are shorn of the existing requirement that states receiving Federal dollars should share in the costs of the programs being financed.

In fact, the block grant proposals pending in both houses of Congress would provide less money in the future, not more. This makes no sense, for, as Senator Daniel Patrick Moynihan has repeatedly said, welfare innovation often costs more money — at least in the short run — for such needs as child care, training and transportation.

Proponents of block grants argue that the savings in administrative costs generated by shifting welfare to the states will provide additional revenue for innovation. But shifting large responsibilities is so untested that such savings are highly speculative.

States will dump the burden on local officials.

What's really going on? "The block grant is the secret device for cutting welfare benefits," Prof. Paul E. Peterson, director of the Center for American Political Studies at Harvard, said recently. "It is a way of avoiding blame for loading deficit reduction onto the backs of the poor."

By handing out block grants, Congress will not have to deal with worsening economic trends, increased unemployment, regional downturns and demographic changes. Statehouses will play the same avoidance games.

Gov. George Pataki of New York proposed turning over block grants for child welfare services to the counties, and the Legislature approved it, with minor modifications. Similarly, other governors and state legislators can pass their obligations to counties and cities.

Mayors and county officials should be dismayed. When Congress and state legislators get through cutting help to tens of millions of needy Americans, the lines of hungry, homeless, sick, poor and abused women, children, elders and whole families will form at county and city offices. State capitals will be remote, and Washington will be even more distant from the social devastation.

Prominent politicians want churches, synagogues and charities to pick up the slack. Never mind that Catholic Charities USA, the Council of Jewish Federations, the Salvation Army, Lutheran Social Services, Second Harvest, Feed the Children, the St. Vincent de Paul Society and many others have all said they cannot make up for tens of billions of dollars cut from the Federal budget.

Congress can expect little from the states. Governors may promise great compassion for the poor, but anyone who has worked closely with state legislators, as I have in the South, can tell you that welfare families, people with disabilities, nursing home residents, the elderly poor and abused children usually score very low on the political scale. Financing for their needs is often shortchanged when it comes to providing dollars for competing highways, schools, businesses and farms.

The 1988 version of welfare reform, the Family Support Act, with its jobs program, proves the point. Billions in Federal dollars made available under it were not used by the states because of an unwillingness to invest matching dollars in poor families or a lack of resources to do so.

Moreover, for years many states have refused to take advantage of the Aid to Families with Dependent Children's unemployed parent program. This would allow the states to help families with both parents at home. Meanwhile, many unemployed fathers leave their families so that the families can qualify for welfare.

The record of the states in protecting children is so sordid that no member of Congress could seriously maintain that child protection will be better under deregulated block grants. The Associated Press recently indicated that 42 percent of the children who died of abuse and neglect in 1993 had come to the attention of state child protection services before their deaths.

So horrible is state protection in many places that nearly two dozen states are under court order to meet their protective obligations to children. Cases drag on for years in underfinanced state and city child welfare systems.

Children are bounced from foster home to foster home — if the system knows their whereabouts at all. And the "graduates" of the child welfare system fill our substance-abuse treatment programs, homeless populations and prisons.

My home state, Louisiana, has made a name for itself by maximizing Federal Medicaid dollars and cutting back state financing for health and human services. This is the kind of political bayou in which Congress would build a block grant system. Contract With America "beneficiaries" would sink out of sight and drown. □

Fred Kammer, a Jesuit priest, is president of Catholic Charities USA.

CLINTON AND DOLE PRESENT PROGRAMS TO ALTER WELFARE

PRESIDENT TAKES ACTION

States Are Given More Leeway but the Senate Leader Says the Move Is Too Timid

By ALISON MITCHELL

BURLINGTON, Vt. July 31 — President Clinton and Senator Bob Dole, his leading Republican rival in next year's Presidential race, presented competing visions of welfare reform to the nation's governors today.

Playing both to the governors and to a broader public widely disillusioned with current welfare programs, Mr. Dole and Mr. Clinton each said welfare must be changed, but they disagreed about the role the central Government should play in fashioning assistance to the poor.

Mr. Clinton, seeking to reclaim the initiative on an issue he capitalized on in the 1992 campaign, told the governors that his Administration had just taken action to move quicker to approve state programs to put welfare recipients to work and would allow states to deny food stamp increases to people who lose welfare benefits for refusing to take jobs.

Mr. Clinton outlined his new executive actions just hours after Mr. Dole described to the National Governors' Association here his own efforts to break a Senate impasse among Republicans over welfare and to build a consensus around legislation that would give each state a lump sum of Federal money known as a block grant to assist poor people.

The reaction among the governors was predictably partisan. Republican governors endorsed Senator Dole's plan and criticized Mr. Clinton for not supporting a complete turnover of control to the states. Democrats said Mr. Dole was advocating a "cut and run" strategy in which the Federal Government cuts benefits and runs from its fundamental responsibility to poor children.

But both men came here to display their concern about welfare to the public, as well as to the governors. Just as Mr. Clinton often promised in 1992 to "end welfare as we know it," Republicans gearing up for 1996 have seized on widespread dissatisfaction with the system as a potent vote-getting weapon.

Mr. Dole, saying that the Federal Great Society programs had failed, announced that the core of his approach was the principle that welfare should be controlled by the states without having to seek approval from the Federal Government. "Governors should not have to play a game of Mother May I," he said, ridiculing the current system under which governors must receive Federal permission, or waivers, to

Continued on Page A10, Column 1

Clinton and Dole Present Competing Welfare Plans

Continued From Page A1

experiment with work programs. "Waivers have led us in the right direction," he said. "Now, let's finish the job. Real change will only occur when you are released from the burden of Federal rules and regulations."

Hours later, Mr. Clinton, in conciliatory remarks, praised Mr. Dole for breaking with conservatives in the Senate who want to require the states to deny cash assistance to unwed mothers and said that was "a very good start for us to work together."

But Mr. Clinton also expressed concerns about a flat block grant for welfare with no requirements that states maintain current levels of spending on the poor, asking what would happen in a recession when

The President uses his office to take immediate action.

more people would be seek assistance. If states have to trim benefits, he said, "I do honestly believe that there is a danger that some states will get involved in a race to the bottom," he said. "This program after all is called Aid to Families with Dependent Children not aid to states with terrible budget problems caused by Congress." The governors responded with laughter and applause.

Mr. Dole accused the White House of standing idly by while Senate Republicans debated welfare proposals. But today Mr. Clinton chose the governors' meeting to showcase the power of the President to act even as the Congress remains deadlocked. Mr. Clinton said, "We don't have to wait for Congress to go a long way toward ending welfare as we know it."

Mr. Clinton announced he was directing the Health and Human Services Department to take no more than 30 days to approve state welfare experiments following any of five strategies:

¶ Require recipients to work but provide adequate child care.

¶ Limit the amount of time people can collect welfare, provided that jobs are available to those willing to work.

¶ Require minor mothers to live at home and stay in school.

¶ Forcing fathers to either pay child support immediately or go to work to pay it if they are broke.

¶ Use welfare benefits and food stamp grants as cash subsidies to private employers who hire welfare recipients.

The waiver process now takes 120 days.

Mr. Clinton said he was also ordering the Office of Management and Budget to approve a change in regulations so that food stamp benefits do not automatically rise when a state reduces a welfare grant for someone who refuses to go to work. "If your welfare check goes down for refusal to work, you food stamp payments won't go up anymore," Mr. Clinton said.

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And the President announced that he was approving four new state welfare experiments — in California, Texas, Utah and West Virginia — bringing to 32 the number of states that have Federal waivers to create their own welfare programs.

The state programs range from California's efforts to establish a cap on welfare benefits per family so that there is no increase with the birth of a child, to Texas's plan to require parents to prove their children have been immunized or face reductions in benefits.

Mr. Clinton vowed during the 1992 Presidential campaign to "end welfare as we know it" and today he called the issue a "symbol of what divides us." But as President Mr. Clinton put health care reform ahead of welfare and Republicans claimed the welfare issue as their own after they took control of Congress in the 1994 elections.

Although Republicans and most Democrats favor tying welfare to work requirements, legislative progress on the issue has been stalled for months by a dispute among Republicans although legislation approved by the House of Representatives and by the Senate Finance Committee are both tougher than Mr. Clinton's proposals and would set more stringent work requirements.

Mr. Dole has been working to broker a compromise around a measure that would change most welfare programs to block grants. State officials would have more discretion than they have now in decide how to use the money. But poor people would no longer have a legal right or entitlement to assistance and the Federal Government would put a cap on total spending regardless of economic need.

But one of Mr. Dole's rival in the Republican race, Senator Phil Gramm of Texas, and 23 other conservative Republican Senators want provisions to cut off cash benefits to unmarried teen-age mothers and deny additional benefits to welfare mothers who have babies.

Mr. Dole, in an indirect swipe at Mr. Gramm's plan, said, "I will do all in my power to insure that our reforms will not increase he tragedy of abortion in America."

Mr. Clinton similarly noted that abortion rates had been declining and "might turn around and go up again at least among some classes of people, if we pass that kind of rule everywhere in the country."

Gov. Howard Dean of Vermont, the Democrat who heads the governors' association said Mr. Dole's speech was conciliatory in tone, but said nevertheless block grants, because of their inflexibility, "are a terrible threat to the states' taxpayers."

And Mr. Chiles said that the assumption that states would take over welfare programs overlooked the fact that "these programs were started by the Federal Government because children weren't being taken care of."

Several Republicans bristled at Mr. Clinton's support for requirements that would keep states from cutting their own welfare expenditures, as Mr. Chiles predicted some would.

Gov. Fife Symington of Arizona said such requirements would curtail the states' abilities to experiment." He also was skeptical of Mr. Clinton's promise that waiver applications would be handled in 30 days, saying one from his state had recently taken a year. "If you were in my shoes," he said, "you would want to get Washington out of your life as much as possible."

Gov. Terry E. Branstad of Iowa, called Mr. Clinton's speech "The same old thing. He is talking about more waivers." He added "I remember when he was a governor when he was with us."

Governor George E. Pataki of New York, while saying he found Mr. Clinton's welfare goals acceptable, complained about his way of reaching them. "The premise of this Administration is you achieve it by going to Washington." He asked, "Why should we need applications to Washington?"

Gov. Michael O. Leavitt of Utah added the complaint that Mr. Clinton's approach "won't move toward a balanced budget."

ten massively long," says Druckenmiller. "I correctly saw that the economy would slow down, and acted on that perception. But I thought it would be temporary"—just a transitory trading opportunity, not the vast source of profits it turned out to be.

If gloom prevailed at the Soros headquarters across from Manhattan's Carnegie Hall, there was considerably greater cheer near Grand Central Station, where Julian Robertson's $1.7 billion Tiger hedge fund boasted an 11.4% gain after fees through July 14. That was the best performance of the hedge fund behemoths. Unlike Soros, Robertson was bearish on Japanese stocks, though Tiger's currency trading was uninspired. The fund's gain was sufficient to make up for a crummy '94, when Tiger fell 8%. Hedge fund managers usually must recoup losses before they can draw incentive fees, which are generally about 20% of the profits.

MACRO MELTDOWN. For the mega-hedge-fund operator who suffered most in 1994—Michael Steinhardt—1995 has started on a generally upbeat note. The $500 million Steinhardt Partners fund gained 9.5%, net of fees, through July 14, lagging the market but far outpacing the 1.8% gains realized by "macro" funds—the fund category, shared by Soros and Robertson, that takes broad, leveraged bets on the global bond, currency, and stock markets. Steinhardt Partners plummeted 33% in 1994, so the fund will have to climb 50% this year to make its investors whole.

Not surprisingly, short-selling hedge funds sustained the worst performance of all. Fighting the tape clearly did not work this year—and the traditional hedge fund strategy of going short as well as long didn't do much better. "Any time you have an explosive upward market, hedge funds are not going to do as well," notes Harry Strunk, an investment consultant in Palm Beach, Fla., who specializes in hedge funds.

But don't sell the hedge funds short. They have a way of roaring back. Take Quantum. It was down 6% at the end of the first half. But then, one of the fund's positions paid off—big time. The gain, to the tune of $250 million or so, erased the loss and put Quantum ever so slightly into the plus column in just under two weeks. What rabbit did he pull out of the hat? Druckenmiller isn't saying. But the size and speed of the gain has all the earmarks of a leveraged bet on currencies. The old Soros-Druckenmiller magic is still alive and well. But it will take a lot more before Quantum will be able to generate the kinds of returns that were realized by ordinary investors who took a ride on the bull.

By Gary Weiss in New York

STOCK MARKETS

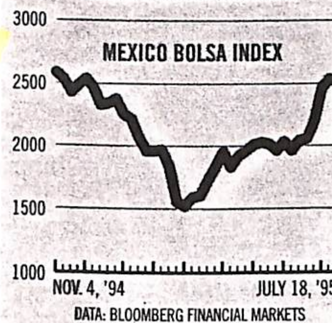
MEXICO BULLS MAY BE HEADING OVER A CLIFF

They could be overestimating this very troubled economy

Just seven months after a currency crisis sent investors stampeding out of the Mexican market, the battered *Bolsa* is charging back. In the past month alone, the index has climbed about 25% as investors went bottom-fishing, searching for value plays and scooping up blue-chips. The rally, pundits proclaim, puts Mexico back on the emerging-markets map.

Not so fast. The numbers are deceptive. The market's latest spurt, which brought the *Bolsa* to a high of 2575 for the year, still leaves the index far from its record of 2881 last year. Moreover, the 4% rise so far this year, after adjusting for the devaluation of the peso, shows a loss of more than 13% in dollar terms. And the *Bolsa* has stumbled in recent days.

WILL THE BOLSA'S REBOUND LAST?



DATA: BLOOMBERG FINANCIAL MARKETS

True, there is some positive economic news to spark investor interest. Domestic interest rates are falling, with the 28-day Treasury Certificate at 41%, down from a high of 83% in March. Inflation was down to a monthly rate of 3.2% in June. The peso is stabilizing. And Mexico has had a trade surplus for several months now, helping reverse a $28 billion current account deficit. The U.S. interest rate cut also revived interest in emerging markets. "Foreign investors are buying the feasibility of the economic program," says Juan Carlos Torres, director of equity analysis at Grupo Financiero Serfin in Mexico City.

But Mexico's problems are severe. Mexican Finance Minister Guillermo Ortiz admits that the country's economy is in a deep recession, with gross domestic product expected to shrink by 4% this year. "Some of the fundamentals are still pretty bad," says Jeffry H. Taylor, chief Latin American economist and investment strategist for NatWest Securities. "A lot of people say the worst is over, but I'm not so sure we can say that yet."

Investors may get that message as second-quarter earnings start rolling in. While a few companies will report small boosts from price increases made last spring, all but exporters will confirm the economy's dismal performance. Although some analysts say the market has discounted those results, a correction may be in the offing as investors dump the underperforming companies and take profits on the stronger players.

BRIGHT SPOTS. Some companies, particularly exporters, are prospering in Mexico's weakened economy, however. Those with revenues from exporting or foreign holdings, such as cement-maker Cemex and mining company Industrias Peñoles, have a stream of hard currency revenues. Where the bulk of their costs are in devalued pesos, these companies should be reporting increased margins.

Despite the strong exporting picture and a few good economic numbers, some investors want more proof that Mexico is on the right track. William Truscott, a member of the Latin American equity group at Scudder Stevens & Clark Inc., refused to join in the recent buying spree and even took a few small profits during the rally. Now he's neutral, noting that "political risk has not diminished one iota."

Such worries are likely to prevent the market from rising much higher this year. *Bolsa* prices already reflect investors' expectations that the economy will limp toward growth next year. Inflation is expected to reach an annual rate of 55% in 1995. "The corporations can't do well without the country doing well," says Truscott. The bulls might want to heed that, if they don't want to get gored by the market once again.

By Elisabeth Malkin in Mexico City

ILLUSTRATION BY RANDALL ENOS; CHART BY ERIC HOFFMANN/BW

STATISTICS

SUDDENLY, THE ECONOMY DOESN'T MEASURE UP

The government's new statistics will make the gains of the '90s look weak

If you had to add up everything produced in the U.S. economy, from apples to zippers, and create an inflation-adjusted measure of national output, how would you do it? The government has been toting things up the same way since 1933, when economist Simon Kuznets devised the present system of national accounts, later winning a Nobel prize for his efforts.

Get ready for a big change. In December, the Commerce Dept.'s Bureau of Economic Analysis (BEA) will make structural changes in the way it computes and presents its flagship measure of economic performance—real gross domestic product. More than that, even without these modifications, the new numbers will have broad implications for the way we perceive the current and past health of the economy.

This is no run-of-the-mill revision. It will dramatically change the face of a familiar economic statistic. Moreover, the new numbers will say that economic growth in this expansion has been a lot weaker than we thought, in part because there has been less business investment. As a result, the productivity gains we thought we were getting will evaporate, dimming hopes for improvement in real wages, living standards, and U.S. competitiveness. All this will raise important questions for policymakers, especially at the Federal Reserve.

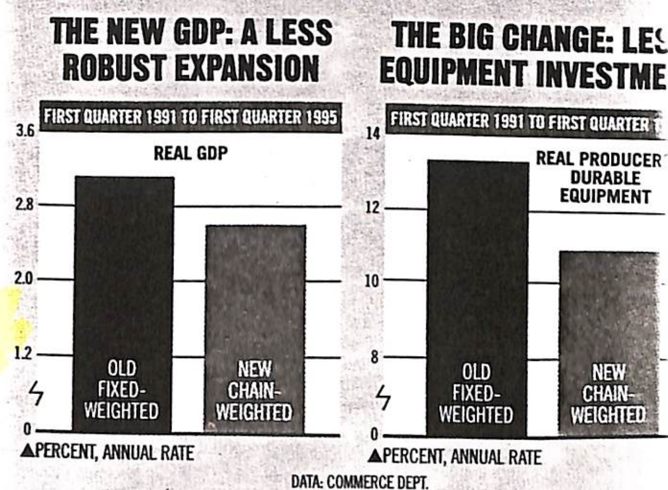
HARD TO FIGURE. To understand what the BEA is doing, consider its task. Real GDP is a weighted sum of 1,100 or so components, including detailed categories of consumer spending, business investment, government outlays, and foreign trade. In an attempt to correct a long-recognized flaw introduced by the current method of adding up the pieces, the BEA will now feature what it calls "chain-weighted" GDP instead of the traditional "fixed-weight" measure. The current measure in constant dollars will be shoved into the background. In its place will be an index, and the BEA will emphasize period-to-period percentage changes. For example, first-quarter real GDP, which now reads $5,470.1 billion in 1987 dollars, will appear as 118.3, meaning the economy has grown 18.3% since the base year of 1987.

It gets worse. Because each GDP component will be an index, you can no longer add its subcomponents to get a total. So traditional analyses of, say, a sector's changing share within the economy or of how much an individual sector contributes to overall growth, will be next to impossible. Want to compare the contribution of capital spending in this expansion to past upturns? Forget it.

To circumvent some of these problems, Commerce plans to provide information on broad sectoral contributions to growth, and it will supply dollar-equivalent measures of the new index. But guess what? The dollar figures won't add up to the total, either, and the further back in time you go, the worse the problem gets.

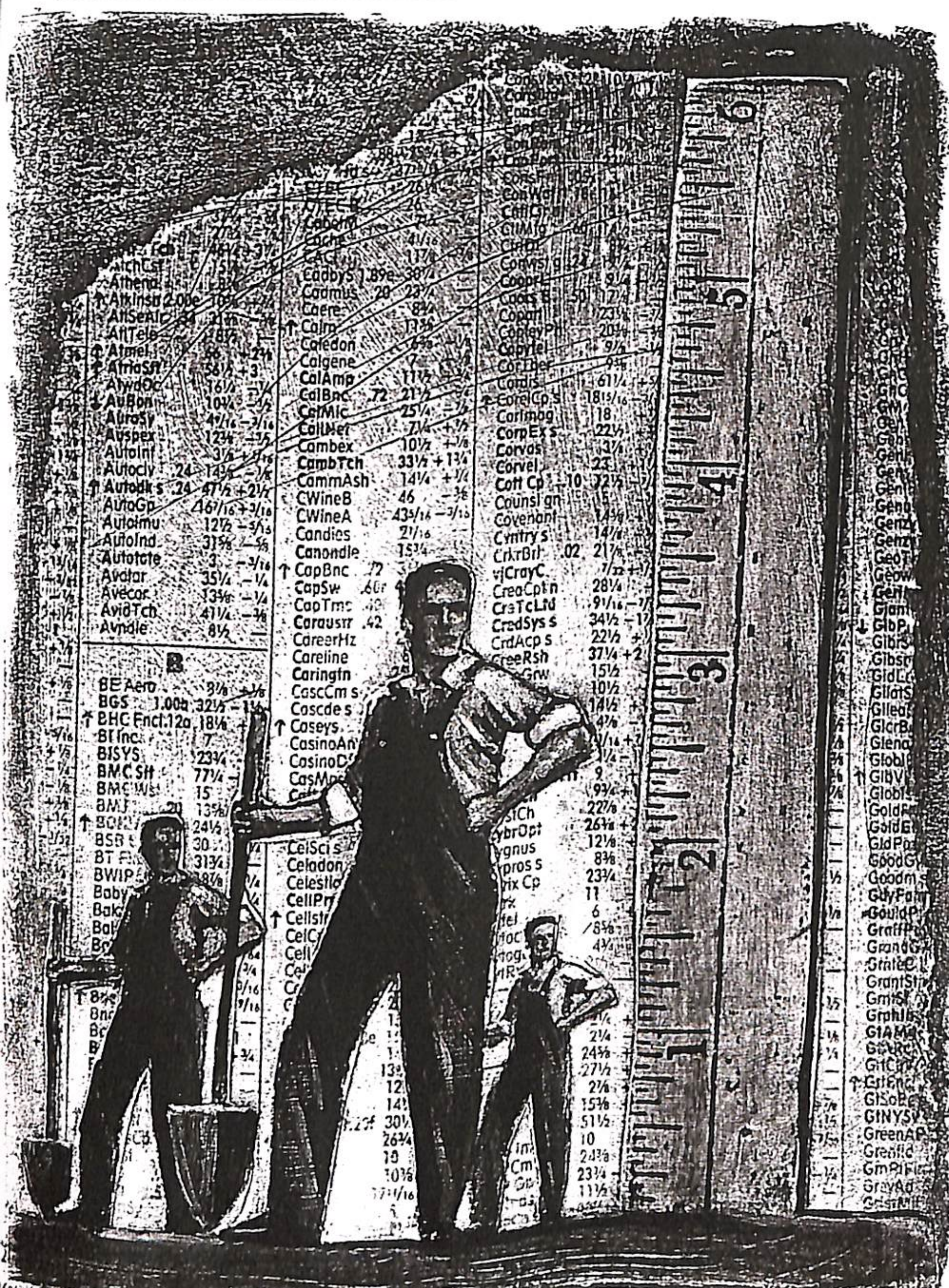
The issues go far beyond familiarity and convenience. For the current expansion, the economy's growth rate will fall to 2.6% annually from its estimated 3.1%—and this was already the slowest upturn in the postwar era (chart). The 2.6% rate is not much greater than the economy's long-term growth potential. Even without the new chain-weighted numbers, the old fixed-weight version of GDP, which the BEA also will update by moving its base year to 1992 from 1987, will yield similar results for recent trends in output.

The expansion's weaker look is partly the result of how the new GDP will treat key categories of business investment, especially computers. That sector has been the real power behind this expansion, accounting for 36% of the economy's growth. Under the new data, it will take a big hit. Of course, the capital-spending boom is still there. Growth in equipment outlays, up 13.4% annually in this expansion, will downshift to a not-too-shabby 11% pace, but the boost to GDP is less than we thought.



The real power behind this expansion has been computers, but that sector takes a big hit under the revised data

The new numbers so dramatically rewrite history that almost every existing interpretation of economic data will have to be reconsidered, especially because of what they mean for productivity growth. Measuring between business-cycle peaks, the old data showed that productivity climbed 1% a year in the three business cycles since 1973 and 2% so far in the current cycle. By contrast, the new estimates show slightly higher gains in the 1970s and 1980s of 1.3% a year vs. a mere 1.4% in this cycle (chart). This is a negligible uptick. "The



new numbers show that the impact of computer technology on productivity has been exaggerated," says Maureen Haver of Haver Analytics, a New York economics consulting firm, and president of the National Association of Business Economists.

LITTLE CHANGE. How is this possible, in light of all the downsizings of recent years? One explanation may be that while many companies cut jobs by substituting new technology, high-tech industries have been on a hiring spree. And overall, companies have hired more workers than they have gotten rid of in this recovery.

Slower output growth also suggests slower corporate sales. Result: Many of the job cuts that experts perceived as lifting output per worker may have simply brought employment in line with this recovery's tepid sales growth. "Most people think that when a company lays off, it produces more with fewer workers," says Larry Mishel, chief economist at the Economic Policy Institute, a Washington think tank. "But many are just producing less, so their output per worker hasn't changed."

The new portrait of the economy also raises troubling questions about living standards and wages. Historically, pay and productivity growth have moved more or less in tandem. So it was no surprise that wages stagnated when efficiency gains slacked off after 1973. Economists have been more puzzled about the 1990s, when apparent productivity improvements have failed to translate into significant pay gains. The revised productivity numbers explain in part the poor performance of wages.

However, the data create another puzzle. Wages outpaced inflation by 1.2% in the two recoveries in the 1970s and by 1% in the 1983-90 upturn, but only by 0.7% in the current recovery. Yet productivity has improved at about the same pace as in prior decades. The implication is that the link between productivity and pay has weakened. It also suggests that the current profit boom—capital returns are at a 45-year high—is not being shared with workers.

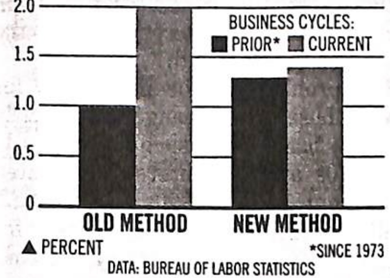
CONFUSION. Less productivity growth is grim news on other fronts, too. Since Social Security is funded by a tax on wages, sluggish pay growth would leave the fund short of money when baby boomers retire. Some experts recently began to think the long-term outlook wasn't that gloomy, since the productivity revival eventually would lift pay. Now, the problem may turn out to be just as bad as everyone had feared.

The most important questions raised by all this, however, are the implications for policy, especially at the Federal Reserve. The Fed was well aware when it cut rates at its July 6-7 meeting that, based on current data, the new GDP would result in first-quarter economic growth of 1.7% instead of 2.7% and that second-quarter growth, to be reported on July 28 and expected to look weak, is likely to be revised downward as well. Looking longer-term, Fed Chairman Alan Greenspan has suggested that better productivity growth will help to stem inflationary pressures. But now, the new numbers seriously question just how much progress the U.S. has made toward improved efficiency.

So why create all this confusion? "Our objective is to provide the best possible measure of real GDP that we can," says J. Steven Landefeld, acting director of BEA. To do that, BEA must eliminate something called substitution bias, which is inherent in the current fixed-weight measure. Right now, the output of every good or service in real GDP is

ARE U.S. PRODUCTIVITY GAINS A MYTH?

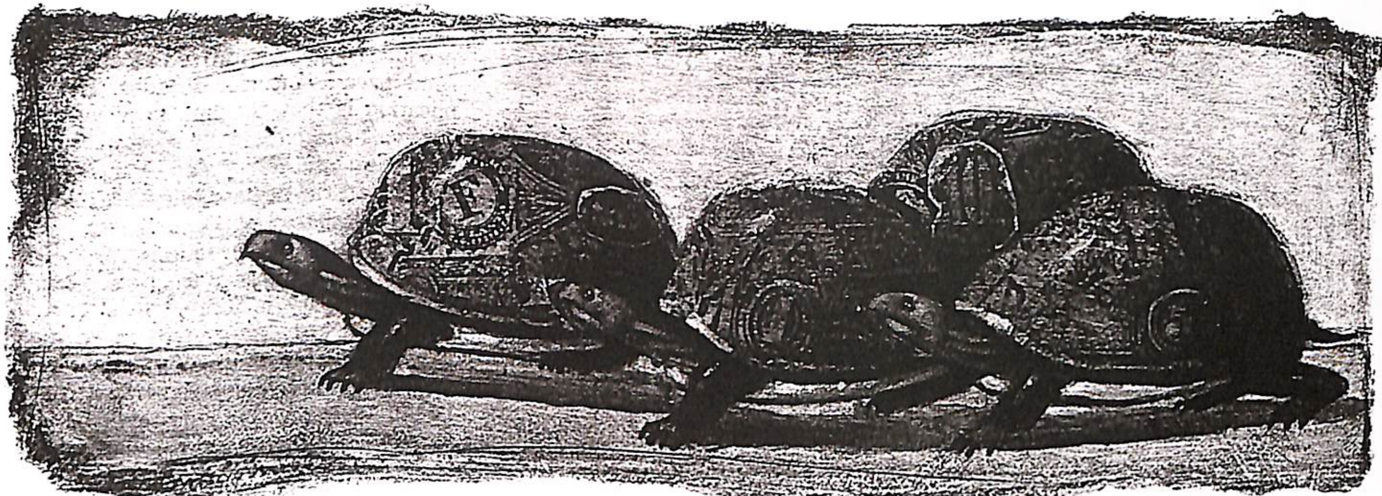
Sweeping new revisions in government statistics show sharply lower growth of output-per-hour in the nonfarm business sector



▲ PERCENT *SINCE 1973

DATA: BUREAU OF LABOR STATISTICS

ILLUSTRATION BY JOSEPH DANIEL FIEDLER



weighted by its price in a base year, currently 1987, and the pieces are added up to get total GDP in constant 1987 dollars. But in the real world, prices change, and consumers and businesses substitute the cheaper product.

Current GDP ignores this swapping. It inaccurately measures output because cheaper products are weighted with the old higher prices. And the distortion gets worse the further you get from the base year. However, the new chain-weighted GDP solves this problem, because the measure accounts for changes in relative prices during each year by chaining together price weights from adjacent years for every year that the GDP index is calculated.

The problem has been severest for goods whose prices change dramatically between base years, such as energy in the 1970s and computers and related equipment in the 1990s. Since 1987, quality-adjusted computer prices, for example, have dropped sharply, but such items are still weighted in GDP by their much higher 1987 prices. As a result, GDP has been grossly overstating the contribution of one of the economy's fastest-growing segments, especially in the most recent years. In this expansion, computers account for about 60% of the overstatement of GDP, says BEA.

PUZZLED LOOKS. This exaggeration can be minimized, but not cured, in the most recent years by shifting the base year forward, as the BEA does every five years. This updating decreases the importance of computers, for example, because of their new lower prices and weighting. But problems remain. GDP in the years prior to the base year tends to be understated. Moreover, the BEA had to face criticism every five years for rewriting history. So it will no longer feature this fixed-weight measure, and the agency will not include it in the morning news releases.

Now, each GDP component will be expressed by an index rather than a dollar figure—making analyses of individual sectors nearly impossible

Economists still aren't sure what to make of it all. When BEA officials laid out their plans in front of about a hundred analysts at the Harvard Club of New York on June 22, there were more than a few puzzled looks and a lot of grumbling. In particular, because the pieces of GDP no longer sum to their total, the change is sending forecasting firms scurrying to revamp their big econometric models to make them compatible with the new data. "What we're demonstrating here is that growth isn't a number. It's one thing in 1987 dollars, and it's another with chain weights," says Edward McKelvey of Goldman, Sachs & Co.

WHAT THE NEW NUMBERS COULD MEAN

- The nation's wealth won't increase as rapidly
- Wages and living standards will grow more slowly
- The Federal Reserve Board won't be able to cut interest rates as easily

DATA: BUSINESS WEEK

Indeed, some economists don't believe the new stats give an accurate picture. Conceptually, everyone agrees that switching to chain-weighted GDP is the theoretically pure thing to do. But GDP will still be far from perfect. "It may take Commerce a few more years to catch on to the productivity miracle of America, but the gains are really happening," says Joseph Carson, chief economist at Dean Witter Reynolds Inc. (page 78).

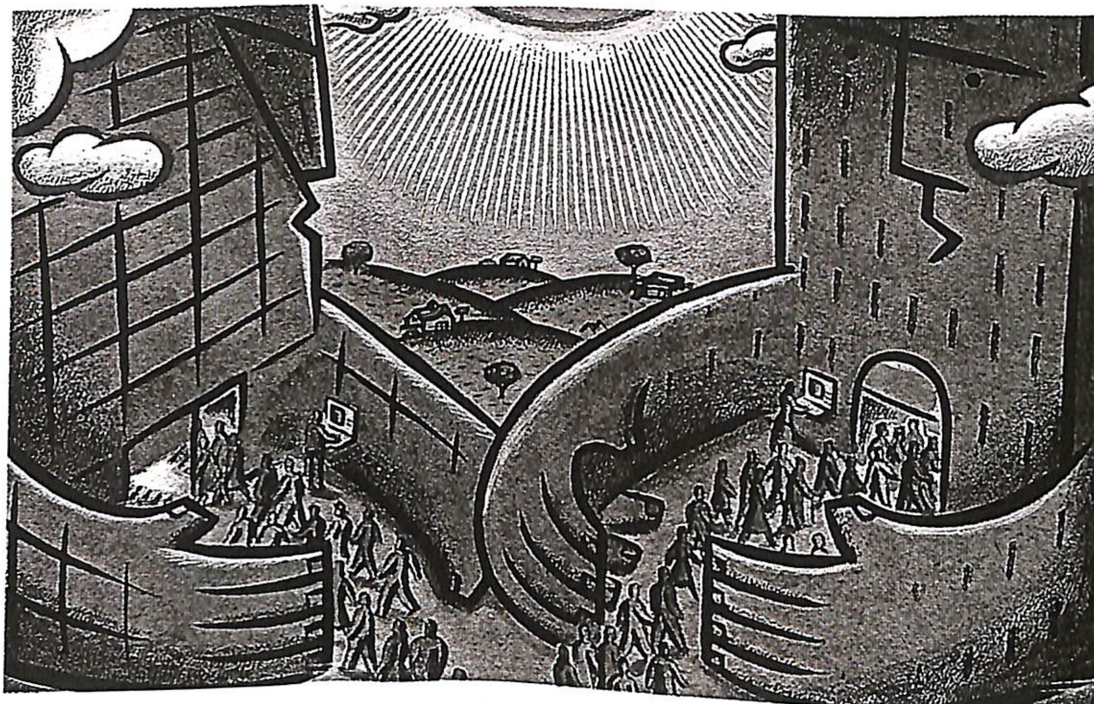
Carson and others argue that removing the substitution bias is fine, but that adjusting for price changes without an adjustment in quality changes, especially in telecommunications and services, ends up understating growth. Moreover, Corporate America's massive investment in computers has begun to pay off, say many economists, as companies replace thousands of workers with computerized technologies. This is particularly true of service output, which government surveys grossly undercount.

Some economists worry about how the public, especially investors, will greet the new GDP data, whose parts will no longer sum to the total. Making matters potentially worse, the BEA may fudge the dollar equivalents of the chain-weighted indexes to make everything add up. Erich Heinemann, chief economist for Ladenburg, Thalmann & Co., goes so far as to say: "I think Congress should hold hearings to assure the public that the Commerce Dept. will not create more problems than it will solve."

If Kuznets were alive today, he probably would applaud the new chain-weighted GDP as an improvement. But paradoxically, under the new method of adding up GDP, perceptions about this economy don't add up anymore.

By James C. Cooper and Aaron Bernstein in New York

See Commentary, page 78



Banks will either have to become high-tech giants—or stay so small their service is truly personal

BANKING

WHY BANKS KEEP BULKING UP

Technology drives the need for capital heft—and mergers

Buy or be bought. That's the watchword for the banking industry, which is in the midst of the biggest wave of consolidation in its history (page 92). At $24.2 billion, the volume of bank mergers announced this year already matches 1991's total. But just as remarkable as the volume of deals is their rationale.

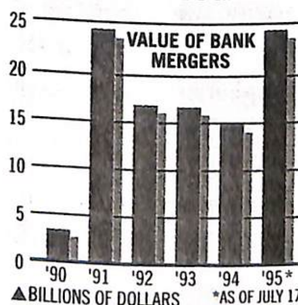
Most deals over the past few years have been predicated on cost savings. But today's deals are different. They consist mainly of strong institutions combining to bulk up to generate new revenues. Above all, they are designed to make possible the capital investments banks must make to be major players in today's financial world.

Banking is becoming a technology-driven business as never before. And increasingly, technology is driving the wave of consolidation. The main reason is that more and more financial products and services, from loans to credit cards, are being marketed through computers and telephones instead of through branches. Other bank services, such as trading and securities processing, are even more technology-intensive. All of this is requiring unprecedented capital investments. A study by Ernst & Young predicts that banks' annual rate of spending on technology will rise 21% between 1994 and 1997. "Technology is a new imperative," says Gerard L. Smith, a managing director in the financial institutions group at UBS Securities Inc., who estimates that $19 billion was invested by banks for technology in 1994, just over half of it by just 52 banks. "Those that can spend on technology are going to dominate the field."

Mergers and acquisitions are the best route to acquire critical mass. That's because the growth in technology spending is far outpacing the growth in banks' earning assets, says Smith. Banks able to make big technology investments gain an unparalleled ability to reach customers nationwide, even though their physical franchise may be limited. Edward E. Crutchfield Jr., chairman and CEO of First Union Corp., calls the advent of new electronic delivery systems for consumer and small-business banking "the single biggest reason" First Union is acquiring First Fidelity Bancorporation, based in Newark, N.J., in a $5.1 billion deal. "This industry is on its way to eliminating the branch as a delivery system," he says. "The cost of converting people to [electronic] banking is in the hundreds of millions. We've now got the opportunity and the wherewithal to convert this system."

BRANCHLESS PUSH. Crutchfield has spent several hundred million dollars on technology over the past several years, including a system to connect all of First Union's branches in a single reporting network. Now, he expects the First Fidelity acquisition to quickly expand his reach but not necessarily in traditional fashion: "The fact that First Fidelity has 700 branches didn't interest me at all," he says. "The fact that they had 2.5 million customers did"—and he will market to them through electronic channels as well as branches.

PUTTING IT TOGETHER



DATA: SECURITIES DATA CO.

ILLUSTRATION BY TIM GRAJEK; CHART BY ERIC HOFFMANN/BW

First Chicago Corp. has similar plans for its $5.4 billion merger with Detroit's NBD Bancorp Inc., announced on July 14. "With more and more products requiring heavy technology spending, you're better off if you can spread the cost over a broader customer base," says Vice-Chairman David J. Vitale. He says First Chicago's payoff will come mainly from selling such technology-intensive products as cash management and risk management to NBD customers. First Chicago's technology spending is now about 15% of total expenses, and Vitale sees that rising, especially in two areas: corporate-client services and electronic retail-banking products. Already, three-quarters of both banks' retail clients do not use bank tellers.

Those few banks that today are able to make big technology investments without bulking up through mergers are already reaping the rewards. Wells Fargo & Co., for one, is reaching across the country with mail and electronic offerings of retail-banking products—even though it does not have branches outside California. In early 1995, Wells began nationwide marketing of preapproved small-business loans through the mail, the first bank in the country to do so, according to President William F. Zuendt.

FALLING BARRIER. Banc One Corp. is also benefiting from technology investment. The Columbus (Ohio) bank has invested heavily in a new credit-card processing system that it's now licensing to four companies, including American Express Co., which will pay $25 million. Bank of New York Co. is taking similar steps in wholesale banking: Since early 1994, it has spent close to $500 million to acquire a dozen securities processing operations, adding them to its own sizable portfolio to gain the economies of scale possible in those heavily automated businesses.

The need for investments in scale and technology is transforming the once fragmented banking industry. Ten years ago, a bank with $10 billion in assets was considered large—but today, $5 billion to $10 billion is a small bank, according to Herbert A. Lurie, co-head of financial institutions at Merrill Lynch & Co. Now, scores of midsize banks, with assets ranging from $10 billion to $50 billion, could lose their independence to the banking behemoths that are emerging. "At the end, you'll have maybe 20 money-center and superregional banks with assets over $100 million, a bunch of [very small] community banks, and some niche banks" that specialize in businesses such as securities processing, says Howard Adler, a partner at Gibson, Dunn & Crutcher. But, he says, "woe to the $20 billion bank" without a core specialty that could assure its survival.

The center may not hold any better on the technology front. Big, technologically strong banks will be able to reach customers across the country. Small community banks will offer little in the way of state-of-the-art electronic banking services, but they will still be able to give consumers uniquely local, personalized service. They "almost have it easier because they can give a degree of service the big banks can't," says Ronald Mandle, an analyst at Sanford C. Bernstein & Co. But there will be little room for banks too big to be truly personal and too small to have electronic offerings that can compete with those from Citibank, Wells Fargo, and others.

How long will the consolidation continue? J. Christopher Flowers, co-head of the financial institutions group at Goldman, Sachs & Co., says that "the psychological barrier to selling your bank is dropping" because nobody wants to be left out of the action. With banks' technology needs expanding daily, the urge to merge can only intensify.

By Kelley Holland in New York, with Richard A. Melcher in Chicago and bureau reports

THE SPOTTED OWLS OF BANKING

What's happening to all the bank presidents? There have been plenty of personnel casualties in the surge of bank mergers, restructurings, and reshufflings. But what's surprising is that the normally august post of president is disappearing—or at least becoming risky.

Look at the evidence. When First Chicago Corp. announced its intention of merging with NBD Bancorp on July 12, CEO Richard L. Thomas extolled the combination's dominance of the local small-business market, its capital strength, and more. But Leo F. Mullin, president of First Chicago and the man many thought would eventually run the place, won't be around to participate in the action. He will be leaving once the deal has been completed. "My own aspirations will have to be realized elsewhere," Mullin says.

MULLIN: *First Chicago's merger has cut him out*

SHANKS: *Heir less apparent at Bankers*

"HAZARDOUS." At Bankers Trust New York Corp., after Chairman and CEO Charles S. Sanford Jr. announced his plan to retire next year, the board said it would conduct a wide-ranging search for a successor rather than simply name President Eugene B. Shanks Jr., until then the heir apparent, to the job. At J. P. Morgan & Co., the new CEO, Douglas A. Warner III, is chairman, CEO, and president all in one. Chase Manhattan Corp. did not replace President Arthur F. Ryan when he left last October to run Prudential Insurance Co. Ditto Citibank, after President Richard S. Braddock left in 1992.

Why do bank presidents seem to be a dying breed? Some say banks, long known for their bloated executive ranks and hierarchical structures, want to become leaner and flatter. What better way to demonstrate that than axing No. 2? But Thomas S. Johnson has another idea. He says that with banks focusing on a few key businesses, it makes more sense to have what amount to chief executives of each business instead of an overall deputy to the top gun. "Being No. 2 is a hazardous occupation, especially in a period of change," he says.

Johnson should know. He was president of Manufacturers Hanover Corp. in 1991 when that bank merged with Chemical Bank, and he was not included in the succession plan. Today, he is chairman and CEO of GreenPoint Financial in Queens. Is he planning to name a president? Not anytime soon, he says.

By Kelley Holland in New York

(TOP TO BOTTOM) PHOTOGRAPHS BY RALF-FINN HESTOFT/SABA; JOHN ABBOTT

productivity—one reason why profits rose last quarter, even as the economy slowed (page 36).

With the inventory problem abating and demand firming, industrial output should pick up in coming months. In July, the heat wave alone greatly pushed up utility demand for the month.

BUT STRONGER DEMAND also means that foreign trade will continue to be a serious drag. The trade deficit for goods and services defied expectations in May, remaining at $11.4 billion (chart). Exports rose by a respectable 1.3% in May, to $64.8 billion. That reflects strong demand overseas for capital goods, which set a record in May, despite a plunge in aircraft exports.

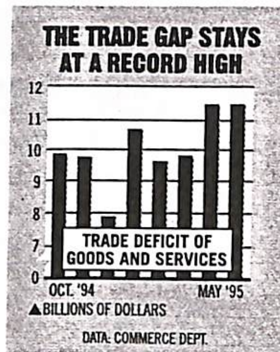
But imports also grew to another record in May, advancing 1.1%, to $76.2 billion. Even as the Fed has tried to choke off domestic demand over the past 1½ years, imports have been surging at a 13% yearly pace. Without some slowdown in this inflow, the U.S. cannot hope to reverse the deterioration in trade.

The June deficit should narrow. Japan has already reported a drop in its surplus with the U.S. (see below). But even if the June gap shrank to $10 billion, foreign trade may have robbed almost one percentage point from the growth in second-quarter GDP.

The import wave is also importing some inflation, a fact noted in Greenspan's testimony. Inflation in consumer-goods imports still trails the rise in consumer prices overall. But the weak dollar and high global demand for business equipment mean that import prices of capital goods have picked up steam.

Such prices have risen 3% from a year ago, much faster than the 0.7% increase of the previous 12 months and the 1.7% pace of U.S. producer prices of capital goods. The gap opens the door for U.S. producers of capital goods to mark up their own prices.

In general, though, inflation remains in the shadows during this expansion. Consumer prices rose only 0.1% in June. Excluding food and energy, prices were up 0.2%. And producer prices of finished goods actually fell 0.1% in June, while the core rate rose by 0.2%.



In the first half of 1995, total consumer inflation is running at a mild 3.2% annual pace, with the core rate up 3.6%. Because the economy is unlikely to grow much more than 2.5% in the next few quarters, few price pressures should materialize.

When combined, the modest inflation outlook and the signs of renewed demand offer the economy the best of both worlds. Don't look for a repeat of the spectacular runup of 1994, but the expansion in 1995 continues to avoid the dangerous shoals of recession.

JAPAN

THE DROUGHT WON'T LIFT

The latest data suggest that Japan's economy contracted further in the second quarter, after almost no growth in the first. The recessionary clouds overhead mean higher unemployment, shrinking profits, and more problems for Japan's frail banking system.

The most recent bad news: Production fell 0.5% in May, as new factory orders, excluding ships and electricity, sank 8.1% from April. Inventories of finished goods rose for the fifth straight month in May, to stand at their highest level in 1½ years. And the jobless rate remains above 3%. That's why it came as no surprise when the Economic Planning Agency's July 14 economic report admitted: "The recovery has stalled." It added: "There's an increasing risk that [the economy] will deteriorate."

The only source of strength has been trade. Japan's trade surplus grew in June, to $11.57 billion, up 2.1% from a year ago. But the trade surplus with the U.S. slipped 11.5% from a year ago. And because of the yen and a slowing U.S. economy, the surplus shows signs of shrinking (chart).

The U.S. trade turnaround is one reason for the recent weakening in the yen. The yen began to slip after the June 28 U.S.-Japan trade agreement. Then the Bank of Japan followed the Federal Reserve interest-rate cut on July 6. The BOJ cut the official discount rate a half-point, to a record low of 0.75%. As a result, the U.S. dollar has traded above 87 yen so far in July—a more tolerable exchange rate for Japanese exporters.

But the yen must weaken further to offer any relief for Japan's banking system. Banks hold more than 40 trillion yen in bad loans. And economists at Hitachi Research Institute calculate that an additional 2 million to 5 trillion yen of loans go awry every year—a worrisome trend given the sinking value of such collateral as real estate and stocks.

The ruling coalition has hinted only at an added 10 trillion yen in fiscal stimulus for this year. But that's little help. Tokyo will have to initiate structural changes to lift the economy's direction.

ERIC HOFFMANN/BW

Economic Scene | Peter Passell

When it comes to farm subsidies, the G.O.P. walks a narrow line.

THE most effective political salesmen often work on the thinnest margins. Consider the Congressional Republican leadership, which must walk a narrow line between new-fashioned, take-no-prisoners conservatism that intrigued voters in 1994 and old-fashioned, scratch-my-back coalition politics.

On the one hand, Republicans are committed to balancing the budget by 2002. On the other, they are as dependent as Democrats on interest groups that favor welfare — in their case, corporate welfare. Perhaps nowhere is the contradiction as vivid as in the struggle over farm policy, a 60-year-old machine for increasing the incomes of favored farmers at the expense of taxpayers and consumers.

Cuts seem almost inevitable: the budget committees in both the House and Senate are asking farmers to spill blood along with other interests. The big question, suggests Edward Hudgins, director of regulatory studies at the libertarian Cato Institute, is whether the retreat will be purely tactical. "Farm lobbies are going to fight to preserve the underlying system," he predicts, accepting defeat on the size of subsidies rather than the fundamental character of the program.

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Not so long ago, few questioned the notion that farming was too risky and too important to be left to the vagaries of free markets. Indeed, the need for a firm helping hand from Washington had a certain plausibility during the 1930's, when a quarter of Americans still scratched out a living on little farms and the Depression left farmers awash in commodities that could not be sold for prices that covered costs.

But that plausibility has been stretched ever thinner as farms consolidated and farming grew more efficient. Today the typical "family" farmer commands millions of dollars worth of land and machinery, and uses commodity futures markets to reduce the risks of price fluctuations.

The New Dealers who let the farm regulation genie out of the bottle probably could not follow the intricacies of the 750-page law that currently determines the price of milk, the output of walnuts, and the type of sweetener that ends up in Mountain Dew. But they would certainly sympathize with the underlying logic of using regulation to augment farm income.

For some key crops like wheat and cotton, farmers are paid the difference between a "target price" and the market price. For others Washington raises prices directly by limiting both production and imports. "It is a Federal crime to sell peanuts without a license," Mr. Hudgins says.

Growers of dozens of varieties of fruits and vegetables have been encouraged to create legal cartels, with the power to force individual farmers to destroy "excess" output. And since all this means that farm commodities are pricey, Washington follows the European Union's strategy of heavily subsidizing exports to keep them competitive in world markets.

Surprisingly, the opening shot in the war on what Karl Zinsmeister, an agricultural specialist at the American Enterprise Institute, calls "farm socialism," came from Senator Richard G. Lugar, Republican of Indiana. Mr. Lugar, the chairman of the Senate Agriculture Committee and a Presidential hopeful, wants to eliminate export subsidies and trim "deficiency payments" linked to target prices. All told, he would cut $15 billion from a business-as-usual budget likely to cost $41 billion.

But the farm lobbies quickly went to work on the House and Senate budget committees, persuading them to recommend cuts of just $9 billion and $5.5 billion over five years, respectively. The idea, it seems, is to delay the mother of all battles over farm regulation until 2000, when the balanced budget deadline looms.

One may well wonder whether "later" is just another word for "never." For example, while Representive Dick Armey, the House majority leader, has railed against the sugar, tobacco and peanut programs, the fact that they cost the Government nothing — consumers simply pay more because supply is artificially limited — makes them far less vulnerable than the big-money subsidy programs, notably corn.

What's more, Mr. Hudgins notes, much of the political sentiment against subsidies comes from the correct assumption that the lion's share of benefits goes to large farmers. If the farm lobbies changed tactics, permitting narrower subsidies targets and making alliances with environmentalists who want to take land out of production, they might be able keep the system of regulation intact.

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But Mr. Zinsmeister remains optimistic that revolutionary change is at hand. Diversification of the rural economy, he notes, is blurring the focus of farm-state Congressmen. And as a result, he says, the once-omnipotent farm lobby is on the verge of becoming a "nine-pound gorilla."

Equally important, Mr. Zinsmeister says, many farmers who viewed subsidies and the restrictions that came with them as a necessary evil are now ready to embrace free markets. "They resent being singled out," he argues. "But with everybody's goodies going," he predicts that farmers will bow to the inevitable.

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Flat-Tax Plan Gets Revisions From Armey

By JACKIE CALMES
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON — House Majority Leader Richard Armey revised his 17% flat-tax plan to blunt projected revenue losses, but it still would force about $40 billion in spending cuts the first year to avoid adding to the deficit.

The Texas Republican joined yesterday with GOP Sens. Richard Shelby of Alabama and Larry Craig of Idaho to announce their bill, just a year after Mr. Armey first called for the flat tax and helped spark a movement to scrap the existing income-tax system. Although Congress isn't likely to act on overhauling the tax code before 1997, and other Republicans have alternative ideas, Mr. Armey predicted, "The bill we are introducing today will become law."

The changes are minor — reducing personal allowances and retaining a withholding system like the current one.

The measure still scraps all deductions except for families and proposes one tax rate — 20% for the first two years, and 17% thereafter — on business income and individuals' wages. Individuals' income from interest and dividends on their investments and savings wouldn't be taxed, because the lawmakers aim to tax business-generated income just once, at the business level.

Critics, particularly Democrats such as House Minority Leader Richard Gephardt of Missouri, assail the flat-tax plan for favoring wealthy stockholders over lower-class wage-earners. Mr. Gephardt has a tax-overhaul proposal calling for several rates that rise with income, to retain the current system's progressive nature. Other political problems for the flat tax are its elimination of popular deductions for mortgage interest and charitable gifts.

The Republicans argued that Americans would forgo those deductions in return for lower, simpler taxes. And they say the plan would be progressive given the impact of deducting its personal allowances — $21,400 for a couple, $10,700 for a single person and $5,000 for a dependent. In effect, a couple with two children earning up to $31,400 a year would pay no income taxes because they'd have allowances of that amount. After the allowances, a family of four earning $50,000 would pay about 6% in taxes, according to the bill's sponsors, while such a family earning $200,000 would pay about 14%.

Those allowances, which would be indexed for inflation, have been reduced from the ones Mr. Armey proposed last year, in an effort to reduce his plan's cost to the deficit. For the same reason, he would keep the current system of withholding taxes from paychecks immediately rather than having taxpayers mail payments monthly.

To keep the plan deficit-neutral, about $40 billion would have to be cut by capping spending for domestic programs, including benefits such as Medicare and farm and veterans programs, but not including Social Security. Such reductions would be on top of those already projected under Republicans' blueprint for a balanced budget by 2002 — calling into question lawmakers' willingness to approve a tax plan that requires even further spending cuts.

Meanwhile, the flat tax has competitors among tax reformers. For one, Chairman Bill Archer of the tax-writing House Ways and Means Committee favors a consumption tax rather than an income tax. In a recent interview, he said he had once favored a flat tax but, "I've sort of grown and matured since then."

WSJ 6/29/95 p A18

U.S. Balance Sheet For Overseas Assets Worsened in 1994

By LUCINDA HARPER
And BOB DAVIS
Staff Reporters of THE WALL STREET JOURNAL

WASHINGTON – The U.S. dug itself into a deeper hole last year.

In its annual snapshot of the U.S. international balance sheet, the Commerce Department said America's debt burden – the difference between the value of foreign-owned assets in the U.S. and the value of U.S.-owned assets abroad–swelled to $680.82 billion from $545.31 billion the year before, when valued by the replacement cost of the investments made abroad and at home. When valued by a market-value index, the trend was similar.

The U.S. became a net debtor in 1987 for the first time in decades, reflecting its persistent need to import foreign capital to offset a trade deficit and a dearth of domestic savings. Inflows of foreign money into U.S. bank accounts, plant and equipment, and bonds increased last year. U.S. investment in foreign securities slowed markedly, the department said.

It also said the British last year replaced the Japanese as the largest holder of U.S. direct investment, defined as ownership of 10% or more of a U.S. company. British holdings were $102.4 billion, down 9.8% from 1993, compared with $99.2 billion for the Japanese, down 3.8%.

Separately, the Labor Department said U.S. import prices rose 1% in May, about three times as much as consumer prices generally, reflecting the continuing weakness of the dollar and increased demand for oil products. Excluding petroleum products, import prices rose 0.8% in May and 5.4% for the 12 months ended in May. Over the same 12-month period, the consumer-price index rose 3.1%, excluding food and energy.

The department said the cost of imported goods from Japan, where the dollar is particularly weak against the yen, rose 1.6% in May, or by 6.5% over the 12-month period.

Global Grass-Roots Banking

The World Bank, the Agency for International Development and eight other donors have joined to finance small loans to the poorest of the world's poor — loans as little as $100, at low interest rates and with no collateral except the borrower's word. These will be loans to underwrite the aspirations of ordinary people, from funds provided by international agencies accustomed to dealing in tens and hundreds of millions, with a level of caring not routinely shown by even a generous local banker.

"Like slavery in the 19th century, the fact that 700 million human beings are hungry in the 20th century is unconscionable," says Ismail Serageldin, a vice president of the World Bank and chairman of the new aid group. "We are the new abolitionists."

The program builds on the successful model of the Grameen Bank in Bangladesh. Founded in the 1970's and still directed by Muhammad Yunus, Grameen has made some two million small loans, mostly to women. There are similar banks — some run by governments, some not — in Indonesia, Kenya, the Dominican Republic and Colombia.

Contributors to the new program have formed the Consultative Group to Aid the Poor, an independent agency. The agency, in turn, will grant or lend funds to the existing small-loan banks and others yet to be established, and will create a global network to spread the movement's scope. At a pledge meeting last month, prospective donors made a tentative commitment to put up at least $200 million. In addition to the World Bank and A.I.D., they included Canada, France, the Netherlands and several multinational agencies.

As an example of what they hope to accomplish, the Grameen Bank's record is illuminating and inspiring. More than 92 percent of its borrowers are women, commonly heads of families. Half have used the money to start raising livestock and poultry. The other half go into handiwork, manufacturing and the trades.

They maintain an admirable rate of repayment — 97 percent, usually within a year. That is better than the rate for poor men in the same program, and much better than the rate for wealthier Bangladeshis with regular bank loans. This is an aid program that works.

Special Interests Are Feasting at the Congressional Trough

As the House Science Committee was writing a regulatory overhaul bill earlier this year, the panel's general counsel, Barry Beringer, was surrounded by Gucci-clad confidants. These were lobbyists representing businesses vitally interested in the legislation. The night before, the majority staff's computers had been generously turned over to the same vested interests.

Mr. Beringer is contemptuous when asked about this blatant involvement of special interests in the legislative process: "I don't have time for that," he says, slamming down the phone. Commit-

Politics & People

By Albert R. Hunt

tee chairman Bob Walker (R., Pa.) says he doesn't know of any direct involvement of lobbyists in the bill drafting and says Mr. Beringer was "reprimanded" for allowing them use of the computers. The nexus of money, influence-peddling and access to legislation is a way of life in Congress. In previous sessions, the Democrats were wedded to the monied interests. But for all the rhetoric about revolution and change, the new GOP Congress has taken the rotten system it inherited and made it worse.

Lobbyists have unprecedented access, directly participating in writing legislation. The Republicans have far outdistanced Democrats in capitalizing on special-interest money—a system that Republicans like Newt Gingrich derided as corrupt when the Democrats were in the majority. And Speaker Gingrich and Senate leader Bob Dole are sabotaging efforts to clean up this mess. Many Republicans claim they are doing only what Democrats did for years. But if special interests too often were the tail that wagged the dog, now they too often are the whole canine.

In a House Resources subcommittee, former GOP Congressman John Rhodes III actually sat on the dais with the congressman during a hearing on Bureau of Reclamation activities. He represented the firm that oversees the central Arizona project. When the Senate Judiciary Committee held a staff briefing on the risk-assessment bill, it was, the New York Times reported, dominated by three lawyers from Hunton & Williams, a law firm that represents tobacco and utility interests. The committee staff director, the newspaper reported, "appeared to defer to the three lawyers about exactly what the bill meant."

Moreover, important GOP leaders are resisting efforts to crack down on the largess these lobbyists dole out to members of Congress, including picking up the tab for meals and so-called charity ski or golf events, where members frolic at the expense of corporations. A bipartisan effort to end these abuses has been ferociously fought by Sen. Mitch McConnell, the champion apologist for special-interest influence peddlers in the upper chamber.

The Kentucky Republican, with the blessing of Mr. Dole, would continue to allow these vested-interest financed junkets and continue to permit lobbyists to pick up tabs of up to $100—every day of the year if they desire.

In the House, Speaker Gingrich, who killed lobbying reform last year, is dragging his feet again. House members' perqs are even more outrageous, including the ability to personally use frequent-flier miles accumulated on official business. Under pressure, the speaker may capitulate on lobbying reform. But that's child's stuff compared with overhauling the campaign financing system—the system Mr. Gingrich used to denigrate as honest graft.

The Republican fund-raising blitzkrieg has been awesome. Political action committees have been shaken down harder than ever. Leaders like House Majority Whip Tom DeLay are shaking down specific PACs for specific members, and newcomers are raising money at an astounding rate. Take, for example, Nebraska freshman Jon Christensen, who after winning a close election, raised $80,000 for the House GOP Campaign Committee, which in turn helped get him a seat on the influential tax-writing Ways and Means Committee. In his first six months as a Congressman, this self-styled outsider has raised more than

Soft Money Donations
To Republican National Committee (in millions)

Jan 1, 1993 to June 30, 1993	$2.1
Jan 1, 1995 to June 30, 1995	11.3

Source: Federal Elections Commission

$367,000, over 35% of it from political action committees. The Omaha World-Herald reported that this is almost four times what his Democratic predecessor, also on the Ways and Means Committee, raised in the similar period two years earlier.

Measures like regulatory overhaul are fund-raising bonanzas; Indiana freshman David McIntosh, a leader of the business interests, has already raked in almost a quarter-million dollars this year. Actually, the money is flowing everywhere there's a GOP label; the Republican National Committee hauled in almost six times more soft money—funds not subject to contribution rules—than in the first half of 1993.

Ever since publicly committing to a bipartisan forum to address campaign financing, while sharing the platform with President Clinton last month, Speaker Gingrich has been backtracking. He has little interest of fulfilling that pledge. In the Senate, Mitch McConnell, with the blessing of Bob Dole, says the current system is just fine and boasts that "reform is not on our agenda."

There is, however, hope that these leaders might be forced to clean up this cesspool. In the Senate, conservative Arizona Republican John McCain soon will introduce a sweeping campaign-financing overhaul with bipartisan backing. In the House, more than a few freshmen are embarrassed by the hypocritical contrast between the rhetoric of change and the reliance on the old corrupt system. Rep. Linda Smith, a conservative from Washington state, won't buckle to leadership pressures to lay off reforming the money system. "This polluted system has to be cleaned up completely," she declares. "Otherwise, everything will break down."

Moreover, if as most Republicans think, Perot voters are key to success in 1996 and beyond, it's worth remembering that the 1992 Perot campaign had two main focuses: deficit reduction, where the GOP Congress has moved forward, and reducing the role of special interests, where it has moved backward. When leading Republicans trek to Dallas in two weeks to address Mr. Perot's big confab, they should be pressed on their dismal performance.

Few people have understood this whole issue as well or as long as John Gardner, who a quarter century ago founded Common Cause as a citizens lobby to minimize the influence of money in politics. Today, 3,000 miles away in California, Mr. Gardner is as persuasive as ever: "This system of campaign financing and money is a cancer eating at the vitals of our system." Rather than "the consent of the governed," he worries, it's more like "the consent of the donors." Mr. Gardner suspects that many in today's Republican majority, like most Democrats in the past, understand the corrosive affects of this system.

But, he notes, "it's an addiction and they can't break it."

contingent jobs. The conference concluded with a session on the policy agenda for addressing labor market transformations. Summaries of the presentations and selections from the discussions appear below.

S Jay Levy on How Employment Depends on Profits

Levy focused on the role of aggregate profits as a source of employment growth. The term "profits" connotes exploitation and negative behavior to liberals, but even they must be reconciled to the fact that the type of society they seek can be secured only if enterprises attain a sufficient level of profits. Although most observers accept the saving-equals-investment identity, few take the time to disaggregate the three principal components of saving: personal saving, government saving, and business saving. Levy asserted that conventional analyses fail to grasp that business saving is undistributed profits.

Inherent in the "profit-centric" system is the principle that "compensation should measure contributions to the production of desired goods and services" in a society. Levy cited his recent research comparing the consumption patterns of the elderly and of working households in the United States during the past decade. Given the growing number of young people "alienated by a dearth of economic opportunity," he concluded that it is in the interest of public officials to stem the disproportionate consumption by the elderly population. Levy stated that prosperity, including employment, is shortchanged when a significant share of profits goes to individuals who fail to make commensurate contributions to the national product.

Frank P. Doyle on Changes in the Workplace

Doyle described the evolution of the public's perception of corporate leadership in the United States from "the gang that couldn't shoot straight" 15 years ago to today's "lean and mean" corporate structure. He reminded the audience of the genuine concern in society, as recently as a decade ago, about the ability of American enterprise to compete in the international marketplace. He attributed corporate America's becoming more effective and more competitive in world markets to a new "way of thinking" that encourages management to be more aggressive and more cost conscious.

Doyle recited the recent history of General Electric. In 1980 General Electric had revenues of approximately $20 billion and employed 435,000 direct workers. It now has revenues of nearly $65 billion and reported profits of almost $5 billion; moreover, it produced these results with only 215,000 direct employees. At the same time, the firm's value has increased to $87 billion. Through a process of downsizing, delayering, and outsourcing, General Electric found that not only did it reduce costs, but it became better. Doyle acknowledged that some of the measures of the 1980s were undertaken "under duress" and that General Electric, in order to secure its competitive position, occasionally had to resort to draconian actions that violated "the expectations of the American work force."

Among larger, "core" employers, the quality of retained jobs is much higher and the jobs are more professional and better paying after restructuring. Doyle remarked that workers at the large and highly competitive enterprises are enormous consumers of personal services and their consumption may encourage employment growth in the service sector, which may be a source of more entry-level jobs. He was skeptical of supply-side solutions to the plight of low-skilled workers, saying that those who preach "Train the workers and the work will come" are perpetuating "an industrial field of dreams." He urged the audience to focus on collective solutions to the problem of declining prospects for individuals at the bottom of the economic job structure. Rather than characterizing the spirit of American enterprise as "lean and mean," Doyle insisted that "it is just necessary."

Anthony P. Carnevale on Employment Policy in the New Economy

In a period of increasing economic anxiety among the public, Carnevale warned that policymakers are engaged in a debate over "false choices" between a "free market retreat" and the "traditional bureaucratic delivery of the welfare state." Instead, he proposed creating some "rights of citizenship

Anthony P. Carnevale

that are economic" and stressed that these rights must be attached to the individual and no longer to institutions.

The view that it is not government's responsibility to provide work for disadvantaged people, yet the government should insist that people work has gained more acceptance by the general public. There is also a breakdown along socioeconomic lines in support for public policies and programs. Employment stability is currently threatened by divisions in society—divisions between socioeconomic classes and between public and private sector workers.

As a means of increasing employment stability, Carnevale proposed a "worker's tool kit" of economic rights that would include education and training, portable pensions, universal health care, family services, and laws to protect job security (such as unjust-dismissal laws). He suggested that such a proposal can bear fruit only if it is promoted for all workers across all industries under the rubric of middle-class entitlements.

Bill Curry on a Shared Prosperity

Curry spoke about the prospects that government could be a constructive factor in promoting equality of opportunity and improving the lives of Americans who are disadvantaged and disenfranchised from mainstream society. Policymakers are perplexed by the fundamental question of the degree to which people's labor is rewarded, and they are limited in their attempts to achieve social stability by absolute capital mobility. They are also hindered by the current desire of the public to "kill" government rather than to fix it. According to Curry, the challenge confronting the Clinton administration is to promote an agenda of active public investment in education, R&D, and other human capital in an environment of fiscal constraint to enhance the nation's long-term competitiveness.

Curry emphasized how language and the tone of public discourse resonate through the policy-making process. He stated that while leaders must maintain core values, they must also identify and test "habits of thought." Curry echoed the Clinton administration's urgent concern about a "fractured social fabric." He suggested that the nation is on the cusp of a new public discourse that will render "all of the old categories defunct, and the prize will go to the person who does the best job of helping to construct a new national consensus."

Session on Macroeconomic Versus Structural Sources of Good Jobs

Susan Dentzer of *U.S. News & World Report* introduced the session with a review of nostrums proposed for the political economy since the late 1980s in the quest for good jobs and high wages. Dentzer posed a series of questions concerning the relevance of concepts like the NAIRU (nonaccelerating inflation rate of unemployment) and the role of technology in the unemployment debate. The participants addressed issues concerning changes in unemployment fostered by technology; the relationship between job skills and productivity, wages, and education; the empirical evidence of the NAIRU; and the role of competition in securing jobs.

William J. Baumol of New York University stated that the crucial element in the current unemployment problem was not the increases in the level of unemployment, but the increases in the duration of unemployment. He argued that the rapid advances in technology have exacerbated the unemployment problem by contributing to increases in the duration of unemployment. Baumol noted that the marked increase in social problems reflects the difference between one

Susan Dentzer

person unemployed for five years and ten people unemployed for six months.

Edward N. Wolff of New York University presented the early stages of his research on the relationship between changes in skills and movements in education, wages, and productivity. He observed three mismatches. First, the changes in the educational requirements of jobs differ from the changes in the educational attainment of workers. Second, patterns of the changes in skills and in real wages are dissimilar. Third, the growth in skills and growth in productivity also differ. These mismatches have serious policy implications.

Focusing his comments on macroeconomic policy and the NAIRU, James K. Galbraith of the University of Texas at Austin argued that macro policy is dominated by conservatives whose basic philosophy is that the markets are self-adjusting and little action is needed regarding problems of unemployment. Liberals are sometimes given the opportunity to intervene in small ways in microeconomic policy. Galbraith also provided empirical evidence suggesting the instability of the NAIRU over time.

Paul A. London of the U.S. Department of Commerce argued for moving beyond the NAIRU debate. London focused on the competitive position of U.S. industries, which he asserted had improved because of deregulation, technological advances, increased trade, restructuring, and changes in the structure of prices that have resulted in less inflation. These changes have allowed increased competition and have made fuller employment possible. London noted that the Clinton administration views good jobs as the key to increasing standards of living.

Session on the Political Economy of the NAIRU

Sylvia Nasar of *The New York Times* cited the active discourse among academics and policymakers on the desire to strike a delicate balance between robust economic and employment growth and price stability. Given the straitjacket on fiscal policy, the debate has centered on the ability and efficacy of monetary policy to achieve this balance.

Robert Eisner of Northwestern University characterized the NAIRU as not just a misconception but a "disaster," which has undermined effective macroeconomic policy. Indeed, fear of inflation, emanating from the suspect model behind the NAIRU, is given as the principal reason to deliberately slow the economy and achieve that ever-elusive "soft landing." Eisner not only cited the absence of any foreseeable inflation threat, but also presented empirical evidence that dismisses the conventional view that lower unemployment generates a risk of accelerating inflation. Thus, he proclaimed, the Federal Reserve's tight money policy was unjustified, and it unnecessarily squelched employment and investment.

Wynne Godley of the Institute expressed regret over the economics profession's embrace of a thesis absent any empirical evidence. He cited the temptation, particularly among young economists eager for tenure, to accept blindly the elegant, yet inherently flawed, econometric model leading to the NAIRU. Godley criticized the "monetarist experiment"—which adhered to the contractionary principles of the NAIRU—in Great Britain after the fall of the Labour government for imposing extreme pain, particularly among the working-class population. For a nation that experienced a "golden age" of uninterrupted growth, no inflation, and full employment for 30 years following World War II, the drastic decline in the standard of living was unprecedented and completely unnecessary.

In addressing the current discourse on the political economy of the NAIRU, William Dickens of the Brookings

Institution described the current attacks on the Humphrey-Hawkins Act by critics who want to amend the Federal Reserve's charter to remove its employment targets and make price stability (i.e., zero inflation) its sole task. Dickens described his model, which assumes heterogeneity in employment, profitability, and wage changes and rigidity in nominal wages. His model supports claims of a long-run Phillips curve, that is, a long-run trade-off between inflation and unemployment, but only at very low levels of inflation.

Stuart Weiner of the Federal Reserve Bank of Kansas City discussed his natural rate model, which represents the lowest possible unemployment rate (approximately 6.25 percent currently) that is consistent with stable inflation. His model has served as the cornerstone of the Federal Open Market Committee's policy to keep the economy from overheating. When some questioned the theoretical basis of his model, Weiner responded by issuing a challenge to his critics to develop a rigorous alternative theory. Weiner reiterated that he was not making a value judgment about an unemployment rate of 6.25 percent; rather, he was simply cautioning observers that aspiring to reduce unemployment below that level through monetary policy will generate accelerating inflation. To redress high unemployment levels, Weiner suggested that economists pay more attention to labor market strategies that focus on the jobs-skills mismatch.

Session on Low-Wage and Contingent Jobs

Howard Rosen of the Competitiveness Policy Council remarked that labor market policies are not immune to the influence of the current political climate in Washington, which is focused on "moving forward," but often without regard to direction or strategy.

Barry Bluestone, a policy adviser to Representative Richard Gephardt (D–Mo.), encouraged policymakers to "universalize" programs typically regarded as helping only the poor. He argued that the Clinton administration's expansion of the earned income tax credit (EITC) can potentially be "not just a solution for the working poor, but a middle-class earnings insurance program of the first order." Indeed, the EITC becomes more important under current conditions of rising contingent work, wage instability, and job insecurity. Bluestone cited data showing that 40 percent of U.S. households would have been eligible for the EITC in at least one year during the 1980s.

Heidi Hartmann of the Institute for Women's Policy Research emphasized the growth of contingent jobs in the United States and emphasized the increasing share of males in the contingent work force. In addition to the widely reported narrowing of the gender wage gap, Hartmann implied that job stability of men and women may also be converging over time. She indicated that there is little consensus on the quality of jobs emerging from a demand-side phenomenon of rising dependence on contingent work, initiated by employers anxious to protect permanent workers and control costs.

Lawrence Katz of Harvard University presented a political dichotomy associated with policy aimed at the low-wage, low-skill end of the labor market: "Making programs universal makes them more politically viable, but then they're so large that they get very expensive, which makes them less politically viable." Katz emphasized the need to concentrate on skill enhancement; there is likely to be much less mismatch between skills and jobs if the human capital stock of the workforce is accentuated. He also reminded the audience of the costs of redressing social ills associated with chronic unemployment. Katz cited research that demonstrates a "relatively high payoff" for employment-matching and skill-building programs in high schools and postsecondary institutions.

William Wascher of the Federal Reserve Board presented research on the minimum wage that he has conducted with David Neumark. They found that an increase in the minimum wage to $5.15 would generate a loss of 250,000 to 500,000 jobs. Their findings differed from those of David Card and Alan Kreuger, who surveyed a series of fast-food restaurants in New Jersey and found no evidence of job loss ensuing from an increase in the minimum wage. Since this debate rests on weighing the costs to individuals priced out of the market against the gains to low-wage workers, Wascher expressed concern that the benefits of a minimum wage increase would be concentrated among suburban teenagers with relatively high family incomes at the expense of displaced low-skilled workers with no alternative means of support.

Session on a Policy Agenda for Addressing Labor Market Transformation

Dimitri B. Papadimitriou of the Institute suggested that technological change and increasing competition have created an economic fault line that runs through the American workplace dividing the upward movement of high-skilled workers from the stagnation facing unskilled and low-skilled workers. This division seems to be aggravated by the relative instability of wages and insecurity of jobs (as evidenced by rising levels of contingent work), opposition to increases in the minimum wage, attacks against the EITC, and pleas for reform of unemployment insurance.

Randall Eberts of the Upjohn Institute focused on regional labor markets and the crucial need to link policy formulation with implementation. He described how his institution balances a wide range of labor market research with the administration of job training programs and eight other state and federal programs for a two-county area in Michigan. In citing regional unemployment disparities, Eberts referred to research illustrating that industry and sector fluctuations prevented getting "from one point of equilibrium to another." Consequently, the efficacy of regional adjustment mechanisms is affected, and the findings suggest that it may take up to 10 years for labor market corrections to be reflected in the improvement of local economies. Eberts also addressed the difficulty of integrating economically disadvantaged workers into the labor market. In addition to the standard prescriptions of education and training, he stated the need for mentoring, counseling, workplace competencies, workplace culture assimilation, and lifelong learning.

David Levine of the Council of Economic Advisers spoke mainly on specific practices used to promote high-performance workplaces. These initiatives emphasize integration of a skilled work force in information sharing (e.g., linking technology with the organization of work), a high degree of structural flexibility, and incentives (e.g., profit-sharing or employee stock ownership plans) that lead to better labor-management relations, greater job stability, and improved firm performance. Levine believes that the promotion of high-performance workplaces is a public policy matter in the sense that it represents a more optimal allocation of capital and labor. He proposed that government can be a constructive agent by promoting the proliferation of high-performance workplaces by providing incentives to firms that demonstrate a genuine interest in adopting these initiatives.

Robert Kuttner of *The American Prospect* suggested that in the economy of 1995 employers need high-performance workplaces with "very loyal, engaged, smart, yet autonomous workers"; at the same time they are "prepared to guarantee just about nothing" for those workers because the alternative for workers is unemployment. He claimed that unless the nation adopts a high-growth macroeconomic strategy, it will have to settle for the full employment definition offered by proponents of the NAIRU. Given the market-driven nature of the competitive economy, Kuttner indicated that the traditional blend of training, wage subsidies, and regional stabilization policies has been rendered void, and the "benign social contract" offered by Anthony Carnevale is "just not going to happen." Kuttner implied that the core obstacle for reconstructive labor market policy is a moral inference "that if the market is working and is yielding results that are progressively more unequal over time," it must be that increasing inequalities are the optimal conditions. He insisted that those who make that inference have not proven the case that laissez-faire is better, and yet that is the presumption of the present era. Instead, he endorsed a very different recipe that involves a mixed economy with constraints on market forces that yields a high growth rate, more stability, and a better distribution.

A complete summary of the unemployment conference proceedings may be obtained by calling 914-758-7700, faxing 914-758-1149, or writing to The Jerome Levy Economics Institute, Bard College, Annandale-on-Hudson, New York 12504-5000.

Annual Financial Structure Conference

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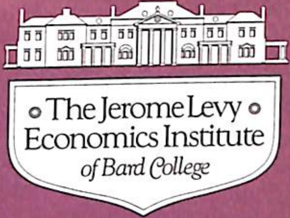

The Jerome Levy Economics Institute of Bard College

LEVY INSTITUTE

The Jerome Levy Economics Institute of Bard College

Report

June 1995

Volume 1, Number 3

Frank P. Doyle, executive vice president of General Electric Company and member of the Institute's Board of Advisors, speaking at the Institute's conference on labor markets

Conference Examines Changes in Labor Markets

As part of the Institute's ongoing research project on the evolution of labor markets and its impact on the quality and distribution of jobs, the Institute hosted a conference, "Reflections on the Eve of the 50th Anniversary of the Employment Act of 1946," on April 28 and 29. Economists, journalists, and policymakers met to discuss issues of employment and unemployment and their policy implications.

Presentations were made by S Jay Levy, chairman of The Jerome Levy Economics Institute; Frank P. Doyle, executive vice president of General Electric Company; Anthony P. Carnevale, chairman of the National Commission for Employment Policy; and Bill Curry, counselor to the President of the United States. Three discussion sessions focused on macroeconomic versus structural sources of good jobs, the political economy of the NAIRU, and low-wage and

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much less check writing, and nationwide clearing mechanisms have already been developed for other products, such as credit cards.

Mayer raised some concerns about these trends. First, these developments will accelerate the transaction velocity of money. Second, they may involve social problems in the form of lost jobs; they may also involve social benefits in the form of facilitating payments not only for middle-class and upper-class people, but also for low-income individuals. Third, the proliferation of aspects of the payments system on the fringes of banking will reduce the efficiency of monetary policy. Fourth, to the extent that local banks lose transaction balances to electronic services, there is the risk of losing the bank lending officer as the decision maker for small businesses. Mayer concluded that there is a national public policy interest in borrowers' doing well.

Gary Stern

Gary Stern on Fashion in Banking and Finance

Although deregulation, technological advance, volatility, and creativity have contributed to the changing role of banks in the financial services market, Stern asserted that the evidence does not support the widely expressed view that banks cannot compete. He cited research findings that banks' lost market share has been greatly exaggerated and that, quite the contrary, banks have not lost share at all. Banks engage in many more activities not only off the balance sheet, but also offshore. Stern added that recent data reveal that the industry is highly profitable and remarkably healthy.

With the passage of interstate banking legislation and the likely reform of Glass-Steagall, banks will have greater opportunities for revenue generation and geographic expansion. Stern remarked that these developments will make banks more important within the financial services industry. Rapid technological change and the movement in Congress toward reducing regulatory burden should also affect the ways banks conduct their business.

Turning to monetary policy, Stern claimed that although monetary policy has become more complex as a consequence of global financial and economic integration, it has not become ineffective. Stern unabashedly stated that the Federal Reserve "should resolutely pursue a policy of low inflation because low inflation will, in turn, contribute to sustained economic growth and financial stability." He explained that economies perform better in low inflation environments because of the positive effects on real resource allocation and on financial stability. He added that financial stability enhances an economy's ability to absorb external shocks, such as increases in energy prices, significant technological changes, or unexpected developments in the economies of major trading partners. Real growth is affected less by such shocks with low inflation and a stable economy.

Eugene Rotberg on Derivatives

Rotberg addressed several characteristics of the current environment for the financial services industry, including volatility in exchange rates and interest rates, huge international shifts in savings, deregulation of financial intermediaries, regulatory agencies with different agendas, increased price volatility, and disintermediation. A final characteristic of the environment Rotberg described is financial engineering, which has led to complex products not easily understood by managers or regulators. Because these products are off the balance sheet, with unknown or uncertain risk, they are not readily subject to traditional accounting and risk management systems.

Richard S. Carnell and Robert J. Giuffra

community groups that use the comment period during banks' application processes to "hold deals hostage."

Roukema commented on the premium differential between the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). Some industry observers have expressed concerns that BIF members will lure away deposits of SAIF members, who will rely less on deposits because of the large premium they must pay, thereby accelerating the erosion of the SAIF assessment base. Seeking to avoid the higher SAIF premium, some SAIF members will seek national bank charters, which will also erode the SAIF base. Roukema concluded that this will be a "watershed year" for the industry. (Congresswoman Marge Roukema is the subject of the Levy *Report* Interview in this issue.)

Session on Glass-Steagall Reform

Several major proposals have been advanced to repeal the Glass-Steagall Act. The Clinton administration, the Senate Banking Committee chairman, Alfonse D'Amato (R–N.Y.); Representative Richard H. Baker (R–La.); and the House Banking Committee chairman, Jim Leach (R–Iowa) have all introduced reform proposals. The bills differ in the degree to which commercial banks, investment banks, insurance companies, and nonfinancial companies would be permitted to engage in each other's business. They also differ as to the resulting regulatory structure. Robert J. Giuffra of the Senate Banking Committee noted that Glass-Steagall reform was an opportunity for real bipartisan cooperation between Congress and the administration and he considered current prospects for reform this year to be good.

Fred Struble of the Federal Reserve Board of Governors argued that the globalization of financial markets through technological advances and financial innovation has rendered the current legislative regime obsolete. Struble asserted that Glass-Steagall repeal would increase access to credit for small- and medium-sized businesses. T. Jefferson Cunningham of the Hudson Chartered Bancorp observed that it would be in the best interests of commercial firms to own banks, but it would not be in the best interests of the banking system.

William C. Hunter of the Federal Reserve Bank of Chicago reviewed the scholarly literature and reported that most of the evidence indicates that the benefits banks would derive from increased diversification in their financial activities would reduce overall risk. Hunter cited research that found evidence supporting an endogenously determined bank structure with the presence of firewalls between affiliates. He noted that one should be cautious about the research's findings because it studied banking firms prior to the passage of Glass-Steagall and the industry today functions within a framework of deposit insurance and institutions that are too big to fail.

Struble discussed the bank-subsidiary arrangement and the holding company–subsidiary arrangement as two alternatives to the universal banking model, in which the securities business is housed in the bank and run by the bank. Hyman P. Minsky of the Institute observed that under the Glass-Steagall regime, banking and financial systems were compartmentalized, and this arrangement would not change much under most of the suggested reforms. Giuffra and others noted that there were still questions regarding the resulting regulatory structure and opportunities for cross-marketing. Cunningham argued that banks ought to have the opportunity to leverage their customer information base.

Maurice Hinchey and Martin Mayer

whole loans. Because small business loans are extremely heterogeneous and relatively low in value, performing due diligence on a package of these loans can be prohibitively expensive.

Among the important issues in the evolution of finance from the consumer's perspective are the changes in the payments system. Debit cards and prepaid "smart" cards—the electronic currency—are the alternatives to the traditional means of payment: cash, checks, and credit cards. John P. Caskey of Swarthmore College predicted that the debit card would merely be a fourth means of payment and would not replace the traditional forms of payment in the next three to five years; basically, it would serve a niche market. In contrast, John Wenninger of the Federal Reserve Bank of New York surmised that the prepaid smart card would probably replace currency to a large extent.

Wenninger also examined the policy implications of prepaid cards. Because the Federal Reserve gives the Treasury the interest income earned from the securities that correspond to the currency portion of its balance sheet, this income source would be reduced with the replacement of currency by prepaid cards. A second policy issue Wenninger discussed was criminal activity. Banks are attempting to keep such activity under control by employing cryptographic technology, hiring outside labs to test their security, and reissuing, upgrading, and recalling cards periodically. However, at this point it seems likely that the next generation of prepaid cards—involving consumer-to-consumer transactions through consumers' hand-held card readers—would be extremely vulnerable to illegal activity.

Session on the Expected Impact of Interstate Banking

David L. Glass of the New York State Bankers Association provided the background of the Interstate Banking Efficiency Act of 1994, which eliminated former regional and reciprocal interstate banking agreements by preempting existing state laws by September of 1995. The act also allows branching through *de novo* branching (starting a new branch) or through the acquisition of a bank or branch. States must "opt in" to interstate branching to permit *de novo* branching and must "opt out" of interstate branching to prohibit branching through merger and acquisition.

J. Mark Leggett of Nationsbank Corporation argued that there is no good rationale for a state to opt out. By opting out, states are isolating themselves from the new banking process and penalizing their interstate customers. However, Peter M. Kravitz of the Independent Bankers Association of America contended that proponents overlook the fact that there are two different banking systems in the United States—one made up of small banks and the other of large banks—and that opting out may be a good decision for states with more small banks. Paul A. Schosberg of America's Community Bankers countered that small banks can benefit from interstate expansion as well as large banks. He added that a successful interstate expansion strategy is one way to lower funding costs.

Kravitz argued that interstate banking and branching will create winners and losers among the states. John Mancuso of Keycorp asserted that opt-out efforts would not work and also remarked that substantial waste would be reduced for multistate bank holding companies under a system of interstate banking and branching.

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Session on an Agenda for the Advisory Commission on Financial Services

The adjourning session of the conference addressed a potential agenda for the Advisory Commission on Financial Services, which was set up by the interstate banking bill signed last year and mandated to study the strengths and weaknesses of the U.S. financial services system in meeting the needs of its users for the next decade and beyond. Participants agreed that flexibility would be a necessary feature of the financial system. Richard S. Carnell of the U.S. Department of the Treasury stated that the system needed the flexibility to adapt to evolving needs and that forecasters should not ignore the ability of financial service providers and regulators to adapt to change. James Chessen of the American Bankers Association noted that the system needed flexibility so that innovation would not be stifled. In advocating flexibility, Gary Stern of the Minneapolis Federal Reserve thought bank managers should be allowed to behave more like other business managers.

Karen Shaw of ISD/Shaw remarked that the current proposals to reform Glass-Steagall offer an anachronistic way of viewing the industry. She insisted that there has been a failure to construct a legal model for the industry that even approximates the actual structure of a highly integrated and diverse corporation with few firewalls. She suggested that the commission review the OCC proposal of expanded bank powers, which she described as a new model for universal banking.

The importance of changing market shares of financial institutions was a point of contention among the participants. James R. Barth of Auburn University thought that the commission should consider the implications of this change. Carnell agreed with Barth that banks' share of assets had declined markedly, but stated that trends in banks' revenue and value added were not as clear in either an absolute or relative sense. Carnell also noted that the shift from banks' traditional intermediation activities to greater reliance on direct finance has affected banks and other financial institutions alike. Chessen commented that by any measure banks' market share has declined in the financial services industry, and he attributed the decline to the regulatory burden imposed on banks.

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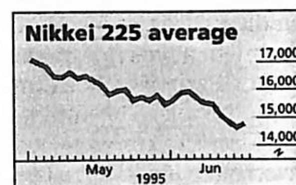
from everybody else, it is hard to argue that only they can do these things. The Swiss have just had more practice.

If other countries want to move deeper into direct democracy, they should note how it is best done. Some subjects are more amenable than others to the whole-people vote. Great constitutional issues ("Do you want your country to be part of a federal Europe?") and specific local decisions ("Shall we expand the town's hospital or its high school this year?") fall more naturally into this category than arcane financial measures, some of which even the Swiss treat with care. And a solid list of signatures should be needed to bring any subject to the vote.

Nothing unconstitutional can of course be laid before the people, though the people can change the constitution if they wish. It is necessary to vote fairly frequently—the Swiss trudge to the polls four times a year—if the voters are to do their task properly (which includes learning how to spot what the selfish propagandist is up to, and correcting the voters' own earlier mistakes without too much delay). Above all, trudging to vote is far better than just prodding a button, because it gives you more time to think. The new electronics is an excellent way of putting more information at the voters' disposal, but it is not the best way for those voters to express the conclusion they come to. Much better, having digested the arguments for and against, that they should walk calmly to the polling station.

Done with care, direct democracy works. The more political responsibility ordinary people are given, the more responsibly most of them will vote. This helps to produce something closer to true government by the people. And that, after all, is the way the logic of the 20th century points. If democrats have spent much of the century telling fascists and communists that they ought to trust the people, can democrats now tell the people themselves that this trust operates only once every few years?

Where a slump might start



Europe and America are worried about economic slowdown at home. A greater danger lies elsewhere

LEADERS of the Group of Seven rich countries, attending their summit meeting in Halifax, Nova Scotia, on June 15th, will have noticed signs that growth is slowing in the United States. As an item for discussion, this suits Bill Clinton. Breaking a self-imposed rule, the White House has recently begun chivvying the Federal Reserve to cut American interest rates; in building support for that view at home, Mr Clinton will find the tacit agreement of other G7 leaders helpful. However, this preoccupation with America's economy risks missing an important fact. There is a much bigger threat to global economic stability, and even to American incomes, than flagging demand in the United States. The real danger is Japan.

It goes without saying that America's economic health matters—not just to Americans but to everybody else. Recent signs of a more abrupt slowdown than the Fed had hoped for are disturbing, and need to be watched (see page 75). But Japan is also big enough to matter to everybody. It is in far worse trouble than the United States. Its sickness is structural rather than cyclical (which makes it more difficult to treat). And to a small but significant extent, out of recklessness or ignorance, American policy is adding to the risk that its economy will crash.

Familiarity breeds content

The depth of Japan's financial troubles has been known, or at any rate suspected, for years. That is the trouble. The world has had time to grow accustomed to seemingly outlandish estimates of the bad debts in Japan's banking system; likewise, to the predictions of breakdown which those estimates imply. Japan has lately endured a bad recession (by its own standards, a dreadful one) and the prices of shares and property have plummeted. Yet the yen continues to soar—which foreigners are prone to mistake for financial strength—and the government has persisted with the policy, such as it is, of muddling through. So far, the scariest forecasts have not come true. That makes it easy to suppose that they cannot come true.

To banish such complacency, consider afresh the scale of Japan's financial mess. Even the upwardly mobile official figures, which still understate the problem, look terrifying. Last week, raising its previous estimate, the government put bad debts in the banking system at ¥40 trillion ($475 billion). That is equivalent to 10% of the country's GDP. Most analysts reckon that the true figure is double that, or more. And the trouble is by no means confined to the banks (see page 76).

In the years since Japan's financial bubble burst, the problem has grown not better, but worse. For lack of growth, the toll of bad debt mounts; banks and insurers are obliged to sell marketable assets, including foreign ones, to meet their own obligations; this keeps the yen high, deepening the plight of Japanese exporters, and turning more debts bad. The Tokyo stockmarket is once more in sight of the point (14,000 on the Nikkei average) at which, it is believed, many of the shares held by Japan's banks and insurers will be worth less than the institutions paid for them. This could accelerate the forced selling of foreign assets. In short, the abyss still looms.

The needed steps are for Japan, not its G7 partners, to take. Monetary and fiscal policy must become more expansionary. Equally important, the government must admit the scale of the bad-debt problem—and prepare the public for the measures that will be needed to deal with it. The worst banks must be closed, their managers sacked and shareholders forced to take the loss; depositors must be protected at taxpayers' (large) expense. Only a thorough financial restructuring, with good assets saved and bad ones written off, will suffice.

If Japan's financial problems, and the needed remedies, are essentially domestic, how can American policy be making things worse? The answer is simple: the persistent threat that small quarrels over trade will be allowed to escalate into exchanges of punitive trade sanctions is unsettling markets that are already nervous. Bad news of this sort is the last thing anybody needs—including Americans, whose interests would not be served by the administration's trade policy even if it "succeeded". In his economic policy towards Japan, Mr Clinton is dicing with disaster. And for what?

The Sharp Slowdown Should Stop Short of Recession

BUSINESS WEEK foresees growth of 2.5% in the next 12 months

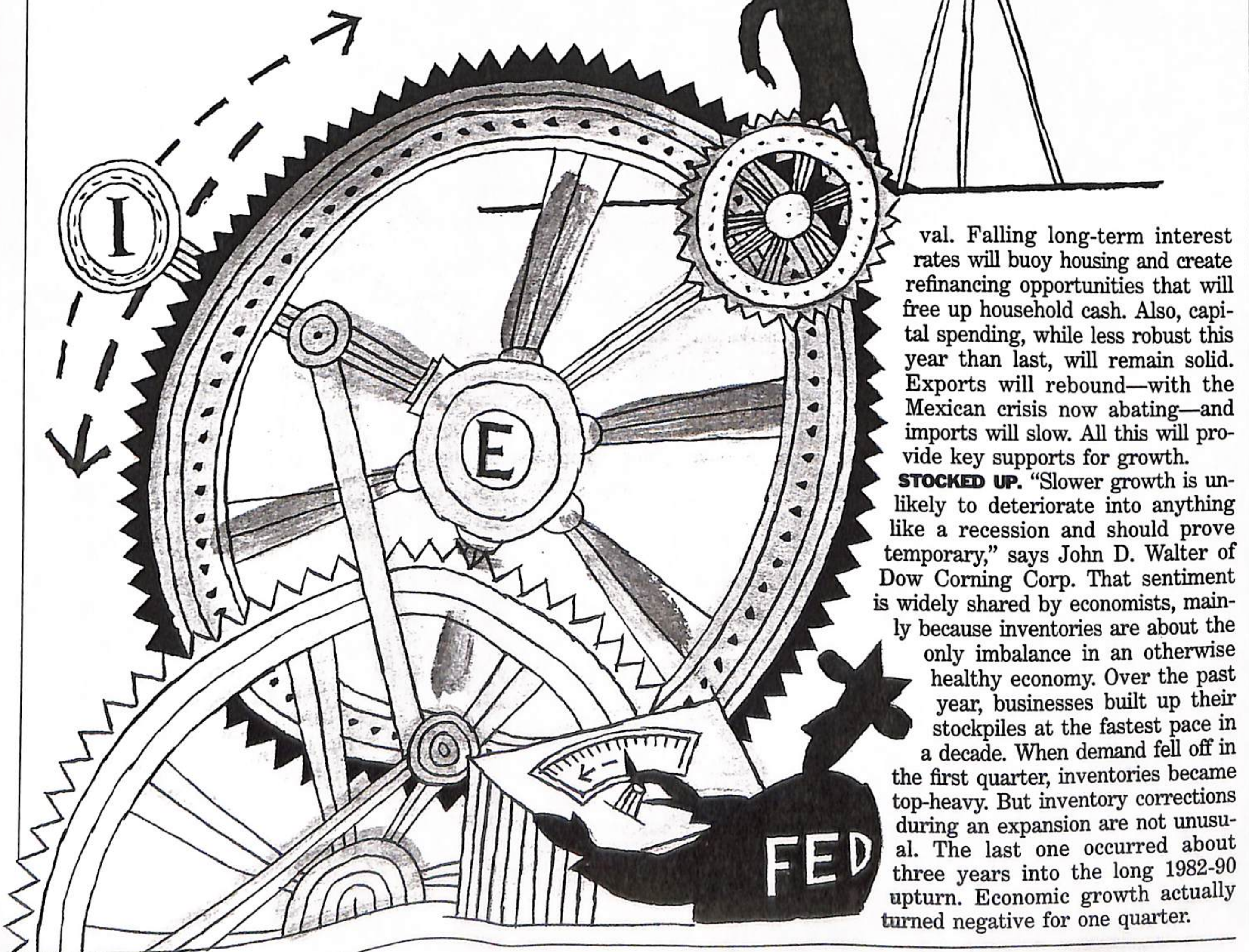
If you want to make an omelette, you have to break some eggs. The Federal Reserve appears to have taken that truism to heart as it attempts to engineer a soft landing for the U.S. economy.

Midway through 1995, the Fed's goal of slowing growth to a noninflationary pace looks like a *fait accompli*, but cracked shells are everywhere: Payrolls are dropping. Consumers are a bit more cautious. And factories are cutting output in the face of excessive inventories. A few indicators even smack of recession, raising a crucial question: Is the Fed serving up a delicacy for the markets or a dish that'll turn your stomach?

BUSINESS WEEK thinks the economic outlook will favor both stocks and bonds. On balance, we expect the economy to grow 2.5% in the coming year, a shade above the 2.3% average of the 20 forecasters we surveyed in late May and early June (table).

We look for the slowdown to be sharp but temporary, concentrated in the second and third quarters. Many businesses are holding excessive inventories, as the impact of the Fed's past rate hikes hits demand. Those extra stockpiles must be worked down at the expense of orders, output, and jobs.

A slower economy, however, is sowing the seeds of its own revival. Falling long-term interest rates will buoy housing and create refinancing opportunities that will free up household cash. Also, capital spending, while less robust this year than last, will remain solid. Exports will rebound—with the Mexican crisis now abating—and imports will slow. All this will provide key supports for growth.



STOCKED UP. "Slower growth is unlikely to deteriorate into anything like a recession and should prove temporary," says John D. Walter of Dow Corning Corp. That sentiment is widely shared by economists, mainly because inventories are about the only imbalance in an otherwise healthy economy. Over the past year, businesses built up their stockpiles at the fastest pace in a decade. When demand fell off in the first quarter, inventories became top-heavy. But inventory corrections during an expansion are not unusual. The last one occurred about three years into the long 1982-90 upturn. Economic growth actually turned negative for one quarter.

The 1995 inventory realignment should not take long. New control systems let businesses react faster to overstocking. Moreover, the imbalance between inventories and sales is heavily concentrated in the auto industry. Detroit's already announced cutbacks should have that problem in check by the end of summer. Also, a lot of the excess retail inventories are imports, which will shift the blow of fewer retail orders to foreign manufacturers.

So what will the economy look like after inventories are in better shape? The best bet for the fourth quarter and beyond is a pickup in growth—not to exceed the "speed limit" of about 2.5% in real gross domestic product that the Fed believes will keep inflation reined in. With current growth apparently dropping well below that pace, the chances are rising that the Fed's next move will be to ease.

Some mild acceleration in inflation, probably to about 3.5% by the end of 1995, up from 2.7% in 1994, seems likely, but the Fed has suggested it will tolerate a small pickup as long as the economy is slowing down. Moreover, efforts on Capitol Hill to balance the budget are likely to exert some drag on the economy beginning as early as fiscal year 1996, which begins in October.

ROBUST EXPORTS. Keeping the economy chugging along will be capital spending and exports. Businesses will continue to invest in high-tech equipment in order to lift productivity—for reasons apart from the ups and downs of the business cycle. Global competition is forcing efficiency. "The recent pickup in productivity is permanent and not just a business-cycle phenomenon," says Michael Keran of Prudential Insurance Co.

And because of increased efficiency, especially in manufacturing, American companies are in a much better position to weather a slowdown. To be sure, profits are set to slow in the coming year from their stellar performance in the past year. But with unit labor costs exceptionally low, profitability will suffer less than in past cycles.

This sharper competitive edge will also make the coming year another good one for exporters. The Mexican crisis dealt U.S. shipments a blow in the first quarter, but export growth will rebound in the second half of 1995. This depends on the expectation that continental Europe's recovery will maintain its recent pace of 2.5% to 3% and that East Asia and Latin America will continue to grow strongly. One worry is a new round of recession in Japan, which could temper growth along the Pacific Rim.

A bigger boost to the U.S. economy, though, will come from the sharp slowdown in imports, as domestic demand wanes. In consequence, the trade deficit is set to improve—a plus for overall growth.

But even with these solid supports from Corporate America and the global economy, consumers will still play the crucial role in how the economy bears up. Fed tightening has already hit household spending hard. Over the past year, outlays for consumer durables and housing are up only 3.2%, down sharply from the 10.1% pace of a year earlier.

Even so, economists are cautiously upbeat. Despite recent weakness, "we still believe consumers will make one more run at the malls," says Maureen F. Allyn at Scudder, Stevens & Clark Inc. May's job drop was not the start of a recession-like wave of payroll cuts. The layoffs were linked to the inventory correction. Once that imbalance has passed, job and income growth will be sufficient to support a moderate pace of buying.

A healthy consumer balance sheet is another force that should prevent recession. The residential real estate market across most of the country will stay solid, supporting house prices. And the rallies in both the stock and bond markets are boosting consumer wealth. The bond rally has also touched off a new burst of refi madness: Home-mortgage refinancings in late May were triple their early-March volume, putting extra cash into people's pockets.

FEELING SCRAMBLED. Consumers, however, will not spend with the same gusto as in 1994. Job jitters will cool the jets of some shoppers. And households took on a record $130 billion in new installment debt in the past year. Add in higher monthly payments on adjustable-rate mortgages caused by past rate hikes, and some households will feel mighty scrambled by 1996.

Of course, any time the economy slows markedly, it becomes vulnerable to shocks. This time is no different. Anything that knocks the pins out from under consumer confidence—from a sudden escalation in U.S. involvement in Bosnia to an additional plunge in the dollar—could be enough to turn the Fed's would-be omelette into dog food. That happened after the Iraqi invasion of Kuwait in 1990. But barring the unknowable, BUSINESS WEEK is betting that the Fed will prove to be a pretty good chef.

By James C. Cooper and Kathleen Madigan in New York

WHAT ECONOMISTS ARE FORECASTING

	PERCENT CHANGE IN REAL GROSS DOMESTIC PRODUCT					
	1995			1996		IIQ '95
	II	III	IV	I	II	IIQ '96
MICHAEL KERAN Prudential Insurance	2.5	3.5	3.5	2.5	2.5	3.0
DANIEL E. LAUFENBERG American Express Fin.	2.2	2.7	3.4	2.8	2.2	2.8
MICHAEL R. ENGLUND MMS International	1.5	3.0	3.0	2.5	2.5	2.8
SAMUEL D. KAHAN Fuji Securities	2.0	2.5	3.0	2.0	2.8	2.6
JOHN R. WILLIAMS Bankers Trust	1.3	2.5	2.5	2.5	2.5	2.5
CAROL A. LEISENRING CoreStates Financial	1.6	2.2	3.1	2.8	2.2	2.5
JAMES C. COOPER & KATHLEEN MADIGAN BW	1.4	2.1	2.4	2.7	2.7	2.5
JAMES R. SOLLOWAY Argus Research	1.5	2.4	3.5	2.1	2.0	2.5
IRWIN L. KELLNER Chemical Bank	1.5	2.3	2.8	2.5	2.3	2.5
L. DOUGLAS LEE NatWest Washington Analysis	1.9	1.2	1.5	3.9	2.8	2.4
KURT KARL WEFA Group	2.1	2.4	2.0	2.2	2.5	2.3
LAURENCE H. MEYER Laurence H. Meyer & Assoc.	0.5	1.7	2.5	2.6	2.3	2.3
MICHELLE COLLEY LAUGHLIN Sanwa Securities	1.2	1.5	3.0	3.5	1.5	2.2
NICHOLAS S. PERNA Shawmut National	2.1	1.8	1.9	2.3	2.7	2.2
DAVID H. RESLER Nomura Securities Intl.	0.8	1.8	2.2	2.4	2.5	2.2
MAUREEN ALLYN Scudder, Stevens & Clark	2.0	2.6	2.3	2.6	1.2	2.2
LLOYD T. O'CARROLL Reynolds Metals	1.4	0.6	2.4	2.7	2.9	2.1
JOHN D. WALTER Dow Corning	1.4	2.1	1.5	1.8	2.5	2.0
ROGER BRINNER DRI/McGraw-Hill	1.1	0.9	1.7	2.5	2.8	2.0
C. HEATHER DILLENBECK U.S. Trust	1.0	1.5	2.5	2.0	1.0	1.8
AVERAGE	**1.6**	**1.9**	**2.4**	**2.5**	**2.2**	**2.3**

DATA: BUSINESS WEEK

U.S. Trade Deficit Rose Sharply in April

Unexpected Deterioration Raises Prospect of Drop In GDP for 2nd Quarter

By LUCINDA HARPER
And ROBERT L. SIMISON
Staff Reporters of THE WALL STREET JOURNAL

WASHINGTON—The U.S. trade deficit unexpectedly deteriorated in April, swelling to $11.37 billion from $9.79 billion in March, the Commerce Department said.

The poor showing casts a bigger cloud over the economy and prompted some economists to again lower their forecast for economic growth in the current quarter, which ends next week.

"The chance of negative second-quarter gross domestic product rises as trade worsens," said Joseph Liro, chief economist of S.G. Warburg & Co. in New York. Gross domestic product is the value of goods and services produced in the U.S.

The widening trade gap was attributed to an increase in imports of computers, cars and other consumer goods and a decline in exports of telecommunications equipment and industrial supplies.

Although the trade surplus with Japan actually improved slightly — narrowing to $5.87 billion in April from $6.14 billion the month before — imports of new Japanese cars to the U.S. grew to $2.4 billion. That was the second-highest figure on record and a point that is certain to put additional pressure on the Clinton administration to keep a tough stance in its battle to force Japan to open its markets to American-made autos and auto parts. Washington has threatened to impose big tariffs on Japanese luxury cars starting June 28 unless an agreement with Japan is hammered out this week in Geneva. Imports of German cars also increased significantly during the month.

The April surge in the dollar value of auto imports, automotive parts and engines appeared chiefly to reflect the strengthening of the Japanese yen and German mark against the U.S. dollar, people in the auto industry said. That makes the dollar value of those cars go up.

Although industrywide figures for unit imports weren't available, both **Toyota Motor** Corp. and **Honda Motor** Co., two of the leading Japanese importers, said their unit shipments of vehicles from Japan actually declined slightly in April from March.

"The only explanation can be the yen's appreciation," said a Toyota spokeswoman. Toyota said it imported 24,460 vehicles from Japan in April, 4.7% fewer than in March. Honda couldn't provide a precise figure but said its imports both of cars and of car parts for its Ohio factories declined in April from March. Similarly, the leading importers of German cars, **Daimler-Benz** AG and **Bayerische Motoren Werke** AG, said there wasn't a surge of shipments in April. The yen appreciated 2.7% against the dollar between the end of March and the end of April, while the mark appreciated 0.8%.

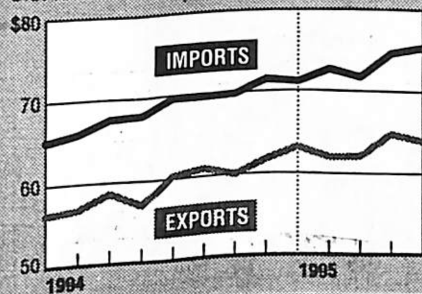
"Even though the deficit with Japan shrunk a little, this report will shore up support for a tough line in trade negotiations," said Brian Horrigan, economist for Loomis Sayles in Boston. "This record deficit will bring home to Washington and the country that we still have not turned the corner on trade. It is still a problem."

The worsening trade picture added to the barrage of weak data about the health

Please Turn to Page A10, Column 3

The U.S. Trade Deficit

Export Growth Tapers Off As Import Growth Slows...
U.S. total trade, in billions



And the Trade Gap With Major Partners Widens
U.S. trade surplus or deficit, in billions

	1994*	1995*
Japan	–$20.48	–$21.57
China	–7.01	–8.71
Canada	–3.42	–5.57
Mexico	0.54	–5.30
Western Europe	–0.27	–2.04
NICs	–2.54	–0.46

*Jan.–April *Source: Commerce Department*

U.S. Trade Deficit Rose Sharply in April, Hitting $11.37 Billion

Continued From Page A2

of the economy and led several analysts to lower their expectations of second-quarter growth.

Merrill Lynch & Co. had assumed the trade deficit would improve in the second quarter. Now, it sees the picture unchanged at best. As a result, Bruce Steinberg, Merrill Lynch's senior economist expects growth in the zero to 1% range this quarter, down from the 1.5% to 2.0% range expected before.

Many analysts were surprised at the strength of imports, considering the weakening of demand. Imports rose 1.0% to $75.35 billion in April. With weak sales, imports are likely to be going into stockpiles, increasing the prospects of slow economic growth in the future as companies work off their excess inventories and pull back on production.

Other economic news has painted a very weak picture of economic performance. The manufacturing sector has slowed significantly, consumer spending is weak, the housing sector continues to falter despite lower mortgage rates and jobs are becoming harder and harder to come by.

Yesterday's trade report also showed that the deficit in goods and services was the largest since a combined record started being kept in January 1992. The goods deficit hit $16.5 billion in April, the third highest on record. As usual the nation posted a surplus in services — it rose to $5.13 billion.

Mr. Horrigan pointed out that the lackluster economic conditions of many U.S. trading partners will likely keep the trade picture bleak. In Latin America, Argentina and Venezuela are experiencing increasing economic problems. And although the U.S. narrowed its trade imbalance with financially unstable Mexico in April, the U.S. is still headed for a record deficit with the country—one with which it usually has surpluses. Japan is also in a weak economic position because of banks laden with bad loans.

"We can knock down trade barriers, but if these countries don't grow, what good will it do?" Mr. Horrigan asks.

Separately, the broadest measure of trade — the current-account deficit — narrowed in the first quarter to $40.50 billion from $43.28 billion in the last quarter of 1994. The current account measures trade in goods and services like the monthly report, and it also tallies investment flows and foreign aid.

All figures, except those for individual countries, have been adjusted for normal seasonal variations.

—*Robert L. Simison in Detroit contributed to this article.*

Regional Trade Balances

U.S. merchandise trade balances by region; in billions of U.S. dollars, not seasonally adjusted

	APRIL 1995	MARCH 1995	APRIL 1994
Japan	–$6.14	–$4.71	–$5.80
China	– 1.07	– 1.42	– 0.60
Canada	– 1.84	– 1.91	– 1.38
Western Europe	+ 0.01	– 0.34	+ 0.32
Mexico	– 1.71	– 1.25	+ 0.17
NICs*	+ 0.59	+ 0.61	– 0.31

*Newly industrialized countries: Singapore, Hong Kong, Taiwan, South Korea
Source: Commerce Department

Here are the Commerce Department's monthly trade figures, in billions of dollars.

	April 1995	March 1995
Total Exports	$63.98	$64.82
Goods	46.92	47.81
Services	17.05	17.02
Total Imports	75.35	74.61
Goods	63.43	62.48
Services	11.92	12.13
Overall trade balance	–11.37	–9.79
Goods	–16.50	–14.68
Goods	5.13	4.89

WSJ 6/22/95 p. A2 + A10

TAX REFORM

TAX REFORM IS COMING, SURE. BUT WHAT KIND?

Radically different systems vie for public and congressional support

TIM GRAJEK

Two years ago, Richard K. Armey, a backbench Republican congressman from Texas, launched an effort to rewrite the U.S. Tax Code. He ordered his staff to run a review of every deduction and credit and even set up mini-debates with aides arguing the pros and cons of each write-off. The result of the exhaustive, yearlong review: "We came up with the current tax system," chuckles former aide Stephen Moore, now director of fiscal studies at the libertarian Cato Institute. "We justified every single deduction."

The exercise convinced a frustrated Armey that tinkering would get him nowhere. Real reform would require nothing less than replacing the entire code with a single low-rate flat tax—a proposal first floated in 1981 by Hoover Institution economists Robert E. Hall and Alvin Rabushka.

Today, Armey is Majority Leader of the House, and his flat-tax crusade rides a crest of voter fury at the current system. A growing band of Republicans—and even a few Democrats—want to destroy the tax law as we know it. "We do not have to accept as a given that the income tax will always be with us," says House Ways & Means Committee Chairman Bill Archer (R-Tex.), who has set tax reform hearings for June.

The campaign has struck such a populist chord that a massive restructuring of the tax laws seems inevitable. The issue could become the economic centerpiece of the 1996 Presidential election. And if a Republican captures the White House, federal tax laws could undergo their biggest rewrite in history. To GOP strategists, cutting the budget is just the first step toward downsizing government; overhauling the tax code is next. Even if President Clinton is reelected, the political momentum is such that the U.S. should see a major redo.

"For the past 15 years, all we've done is tinker," says Larry Langdon, tax vice-president at Hewlett-Packard Co. "We need a fresh vision and a fresh start." Agrees Senate Finance Committee

America's Dueling Tax Plans

THE CURRENT INCOME TAX A top rate of 39.6%, riddled with loopholes, favors consumption and debt over savings and equity. Taxes dividends twice. Simple for most individuals but agonizingly complex for business and anyone who invests.

VALUE-ADDED TAX An integral part of the tax systems of most industrialized countries. Levied at each stage of production and built into the cost of goods. Simple in theory but in practice filled with multiple rates and exemptions. Credited to exports but imposed on imports.

FLAT TAX In its pure form, imposes tax at a single rate for business and individuals, with no deductions or credits. Removes the tax code from investment decisions, favors neither debt nor equity, capital nor labor. A big personal exemption improves progressivity for working families, but the wealthy get the biggest benefit. Top rate about 20%.

USA TAX A hybrid that favors investment over consumption. No tax is paid on savings and investment but is levied on spending. Much like a VAT, except tax is paid annually rather than on individual purchases. Personal tax works like an IRA. Top individual rate is 40%, but workers and employers get credit against payroll taxes.

Chairman Bob Packwood (R-Ore.): "The mood is there. The public is waiting for this."

While the anti-income taxers agree on the problem, they are deeply split over the solution. Each vows to raise the same amount of money as the current income tax system, but by very different routes. Some, such as Armey and Packwood, favor the flat tax. For individuals, it would tax all wages and pensions at a single flat rate but exclude investment income. Business, meanwhile, would pay tax on revenues, less the cost of labor and capital.

Under the flat tax, as well as the hybrid "USA Tax" designed by Senate Budget Committee Chairman Pete V. Domenici (R-N. M.) and Senator Sam Nunn (D-Ga.), people would file tax returns much as they do today. But the USA levy would tax individuals only on what they spend, rather than on what they earn. All investment income would be tax-deferred. Business would deduct all capital costs, but not wages and salaries.

FOURTH CAMP. Other reformers, including Presidential candidate Senator Richard Lugar (R-Ind.), back a national sales tax. Levied only on retail purchases, it would operate much like state sales taxes do. A fourth group, led by Representative Sam M. Gibbons (D-Fla.) and Senator Ernest F. Hollings (D-S. C.), favors a European-style value-added tax, which would be imposed at each stage of production, rather than just at final sale.

The front-runner for the GOP Presidential nomination, Senate Majority Leader Bob Dole of Kansas, and his chief rival, Senator Phil Gramm of Texas, both favor rewriting the tax code, but neither has endorsed a specific plan. Dole and House Speaker Newt Gingrich (R-Ga.) have dispatched Jack Kemp, a GOP tax reform stalwart, to design a plan that the Republican Party can promote in '96.

Meanwhile, some Democrats are devising their own less radical proposals to repair—rather than replace—the current income tax. Senator Bill Bradley (D-N. J.), an architect of the 1986 Tax Reform Act, would like to close loopholes and lower the top rate to below 30% from the current 39.6%. And President Clinton, worried about having to defend the current system in his reelection campaign, is searching for an alternative that aides say would boost savings while preserving progressivity.

While Clinton talks repair, Republicans vow an overhaul. To economists, all the GOP variations are essentially consumption taxes. Unlike the current code, which taxes income, these proposed levies tax you on what you buy—not what you earn. With the sales tax and the VAT, the levy is collected at the time of purchase. With the flat tax and the USA tax, you simply deduct savings and investments from your tax base, so that you're taxed only on what you spend.

While these variations are trivial to macroeconomists, who believe that any consumption tax would spur savings and investment, the differences are vast for taxpayers—and politicians. Exporters would reap a big windfall under the USA and VAT taxes, since they'd get a credit for goods shipped overseas—a benefit not provided by the flat tax.

In contrast, under Armey's flat tax, wages are deductible for business while taxable to workers. But with the Nunn-Domenici tax, companies lose deductions for labor costs, while individuals are taxed only on the wages they spend. "The most interesting dividing line is between labor-intensive and capital-intensive businesses," says Price Waterhouse Partner Peter Merrill. "Repealing the corporate income tax is not neutral across industries at all."

LOSERS. Overall, the flat tax would provide a generous tax cut for many individuals, but it would be funded with a big tax hike for nonfinancial corporations (page 86). Companies hooked on debt—real estate developers, homebuilders, and some manufacturers—would lose their most lucrative write-offs under all of the consumption-based rewrites. And no one has yet figured how to tax financial companies, such as banks and insurance companies—a possible deal-buster.

Whatever their specific tax proposal, most reformers agree on two goals: Income should be taxed only once, and the current bias in favor of debt and consumption should be ended. Why? The U. S. national savings rate is among the lowest in the industrialized world. And

How They Stack Up

Depending on which tax-reform scheme U.S. lawmakers choose, individuals and businesses could receive radically disparate tax bills

THE IMPACT VARIES WIDELY AMONG COMPANIES...

TAX LIABILITY FOR A $1 MILLION...	CORP. INCOME TAX	ARMEY FLAT TAX 19%	ARMEY FLAT TAX 23%	USA TAX	5% VAT
MANUFACTURER	$9,941	$13,899	$16,825	$19,514	$15,336
SERVICE COMPANY	8,142	12,387	14,995	15,056	21,913

...BUT INDIVIDUALS USUALLY PAY LESS

TAX LIABILITY	INCOME	CURRENT LAW	ARMEY FLAT TAX 17%	ARMEY FLAT TAX 19%	ARMEY FLAT TAX 23%	USA TAX
FAMILY OF FOUR	$75,000	$9,121	$6,155	$6,878	$8,326	$8,894
	150,000	28,415	13,296	14,860	17,988	30,704
	300,000*	77,220	42,262	47,233	57,177	77,205

*Excludes business or partnership income

DATA: ECONOMIC POLICY CONSULTING GROUP, PRICE WATERHOUSE

The flat tax ditches cherished deductions for mortgage interest and charitable donations

economists believe stronger savings will translate into increased investment, which in turn is key to future growth.

There is little doubt such economic goals are important. But public support for tax reform is being driven by something quite different—a desire for simplicity and a widespread belief that many payers are shafted by the current system. "First of all, people hate the IRS," says Gingrich flatly. Adds Grover G. Norquist, president of the antitax Americans for Tax Reform: "It's a great idea to eliminate the IRS root and branch."

A new poll for Andersen Consulting reports that 59% of the American public believes it is too difficult to fill out federal tax forms. And even major corporations find the law mystifying. "Our existing system is so overwhelmingly complex that it's draining administrative resources on the taxpayer side and on the government side," says Lisa Norton, tax counsel at Ingersoll-Rand Co.

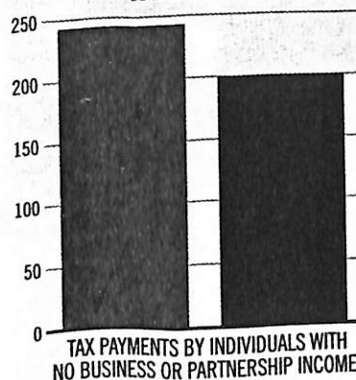
BOON? Still, much as they hate the current code's complexities, business has learned to live with it—or even profit from it. So while reform may be an economic boon for the country as a whole, the transition could be agonizing for specific industries, such as real estate.

Is radical reform worth it? Many economists think so. Boston University economist Lawrence J. Kotlikoff figures replacing the current code with a savings-enhancing sales tax would boost the nation's stock of capital equipment by as much as 63%. That new investment would spur productivity. The payoff: Living standards would rise by up to 18%, he argues. Such predictions have been challenged by critics, and some reformers concede they can't guarantee major gains. "Will it really increase savings?" asks Domenici. "We have no way to prove that absolutely."

That's one reason the GOP plans differ so much, as each tries to strike the perfect balance between fairness and simplicity while maximizing U.S. economic growth. Just look at the Armey flat tax, tailor-made for a public that is fed up with often-incomprehensible rules and overpriced accountants. Unlike the current IRS maze, it's nothing if not simple—add up what you make, take a big standard deduction, multiply by the tax rate, pay the tax, and get on with your life. But there's a price: ditching some cherished tax breaks, including deductions for mortgage interest, state and local taxes, and charitable contributions. "I want to capture every penny of income in the tax base and subject it to taxation only one time," explains Armey. "The taxpayer would get an honest tax bill that's simple and direct."

Flat Tax: Boon or Bane?

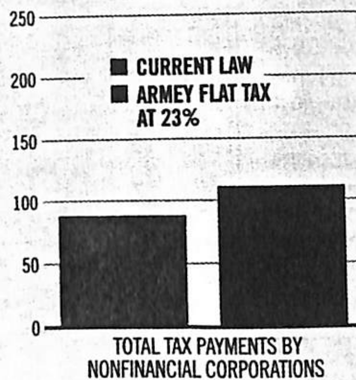
INDIVIDUALS GET A BIG BREAK...



TAX PAYMENTS BY INDIVIDUALS WITH NO BUSINESS OR PARTNERSHIP INCOME

▲ BILLIONS OF DOLLARS

...WHILE CORPORATE TAX BILLS JUMP



TOTAL TAX PAYMENTS BY NONFINANCIAL CORPORATIONS

▲ BILLIONS OF DOLLARS

DATA: ECONOMIC POLICY CONSULTING GROUP, PRICE WATERHOUSE

For business, Armey's tax would be levied on cash flow. Companies would take total income, subtract capital and labor costs, and pay a tax on the difference. They could immediately write off all costs of producing goods, including capital investment and wages. But the cost of money—raised through debt or equity financing—would not be deductible. Manufacturers that buy lots of new equipment would benefit; companies that are heavily debt-financed would suffer.

Exactly what Armey's flat rate would be is hotly debated. He publicly sets it at 17% but concedes that won't raise the same revenue as current law. The Treasury Dept. figures the rate would have to be about 23% for the tax to be revenue-neutral, while flat-tax guru Hall estimates 19%.

Regardless of which number you use, corporations would take it on the chin. According to an analysis by Price Waterhouse—using 1991 return data—if the flat rate was 19%, nonfinancial corporations would pay one-third more in overall taxes than under current law, while individuals would pay about one-third less. Income from sole proprietorships, partnerships, and the like—now taxed at the individual level—would be reported on a separate business return.

The Nunn-Domenici tax scores high for being fair and encouraging savings. For business, the plan is similar to a flat tax, except that wages are nondeductible. This could hurt labor-intensive companies, but they get a big break in return: a full credit for all Social Security taxes, which now shrink the bottom line. U.S. manufacturers, especially big exporters, should like the USA Tax. They would get an immediate write-off for capital investment. And goods sold overseas would be exempt from U.S. taxes, while imports would be taxed at the border, making them more costly.

A BIG IRA. Nunn-Domenici's individual tax essentially creates one huge IRA. People would take their total income from all sources, subtract what they save and invest, and pay tax on the difference. Reinvested dividends and capital gains, money deposited in savings accounts, and investments in stocks or mutual funds would be deducted. So would some mortgage payments, charitable contributions, and limited education costs. And individuals would get a credit for payroll taxes. The levy would resemble a sales tax, but people would pay annually or quarterly, rather than every time they made a purchase. Winners and losers can be summed up simply, says Nunn: "Those who save will pay less taxes than those who spend."

But the Nunn-Domenici tax is by no means simple. And neither it nor the flat tax would shutter the despised IRS. That's why some pols would dump the income tax system entirely and replace it with a sales tax. No more forms. No more withholding. No more scrambling for 1099s. And no more IRS.

DAVID BURNETT/CONTACT

SOUNDS SIMPLE

"I want to capture every penny of income in the tax base and subject it to taxation only one time. The taxpayer would get a bill that's simple and direct"

— RICHARD ARMEY

Archer, who dismisses even Armey's flat tax as too timid, vows to "tear the income tax out by its roots." He wants to repeal the 16th amendment, which established the federal income tax 82 years ago, adopt some type of national sales tax, and scrap the tax agency. He even hints that he would eventually replace the Social Security and Medicare payroll taxes with a sales levy. Archer's top objectives: "Get the IRS out of our individual lives" and exempt exports from tax.

So far, there are two sales tax versions gaining currency—a retail levy and a European-style VAT, which would be set at about 5%. It is paid at every stage of production and is usually hidden in the final price of a product. In Europe, though, VATS have become quite complex and riddled with exceptions.

The national sales tax would be imposed only on the retail purchaser. It could be collected by the states, thus eliminating nearly all of the federal tax-collection apparatus. It would also be administratively simple—unless it begins exempting food, medicine, and other essential purchases. Backers envision a levy of around 20% on all goods and services, even though such a hefty price hike could generate substantial sticker shock among consumers. Archer says the price jump would be offset by a sharp rise in take-home pay, since there would be no income tax. But to libertarians who support a sales tax, the shock effect is its great virtue. "I want people cursing the government every time they go to the 7-Eleven to buy a grape Slurpee," says Cato's Moore.

A lot of people, however, would curse the sales tax for another reason: It's inherently unfair to the poor, who consume a much larger share of their income than the rich. In fact, the various consumption tax schemes are distinguished by how they attempt to achieve fairness.

The flat tax addresses the problem with two rates: zero on roughly the first $36,000 a family of four earns, and about 20% on everything above that. Such a scheme is great for those at the top and bottom of the income ladder, but Treasury figures that families earning between $20,000 and $50,000 would actually face a big decline in aftertax income—about 4.5% under a 17% rate.

BIGGEST HURDLE. Nunn and Domenici would maintain progressivity with multiple tax rates and with their payroll tax credit. But they also pay a price: a top rate of 40%—twice that of a flat tax—and more complexity. Backers of a retail sales tax are mulling creative ways to provide everyone with about a $5,000 credit—such as sending a check to every American with a Social Security number.

Solving the fairness problem, however, pales compared to the challenge of managing an orderly transition to an entirely new tax code. "One of the biggest hurdles is how you get from here to there," says Charles W. Rau, who heads the tax department at MCI Communications Corp. One example: Many financially struggling companies, such as LTV Corp., have stayed afloat by relying on old net operating losses, which they can carry over from year to year. Those losses would disappear in a consumption tax, and troubled companies won't easily give them up.

Likewise, there's the shock to the housing industry. This year, residential housing is being subsidized to the tune of $90 billion. Eliminate the deductions for mortgage interest and state and local property taxes, and the real estate market could plunge into turmoil.

The National Association of Realtors is already gearing up to do battle. It's begun forming alliances with commercial developers, farmers, and other business groups that rely heavily on debt financing. Another possible ally: state and local governments, which would lose their tax advantage for municipal bonds in a world where all investment income is treated alike.

The prospect of fierce resistance from such powerful would-be losers convinces some veterans of past tax battles that the current income tax will never die. Bradley, for one, thinks the eventual outcome of the tax debate of the '90s will be a rerun of the '86 overhaul—"lower rates and fewer loopholes." But, in truth, it's too soon to predict a firm outcome. "Where we end up won't look anything like the original ideas," says HP's Langdon.

Certainly, the drumbeat for tax reform keeps getting louder. At the very least, the next Presidential election will set the stage for another dramatic reform of the current income tax code. And if the GOP takes the White House in 1996, the next stage in the Republican revolution may be a new federal revenue system. The result: By the turn of the century, the U.S. could well become the world's first industrialized nation that won't have an income tax to kick around anymore.

By Howard Gleckman in Washington

A FLAT TAX THAT AMERICA MIGHT BUY

Bet you can't guess how much it costs Americans to file their taxes. The tax code has become so complex (3,458 pages) and so intrusive (the Internal Revenue Service gets more than 1 billion Form 1099s annually to track interest, dividends, and other forms of business income) that the cost of compliance can be measured in billions of hours and billions of dollars. Individual Americans, including the self-employed and the owners of small businesses, spend about 2.1 billion hours each year to do their taxes, while big corporations take a bit longer—3.6 billion hours—to pay their corporate income taxes, according to economists James L. Payne and Arthur Hall. Dollar cost? About $57 billion for individuals and $175 billion for companies. Then, of course, there is the cost of maintaining the small army of government tax collectors—$13.7 billion for 136,000 IRS and other federal agents.

No wonder the drumbeat for a flat tax or some version of a consumption tax is getting louder and louder in Washington. The current tax system has serious problems. It does have a high level of compliance, but it is convoluted, opaque and open to manipulation by special interests. Even the ongoing effort to cut taxes is rife with examples of special-interest lobbying. Social conservatives want a $500 children's tax credit to bolster the family, investors and high-tech startups are pumping for a capital-gains rate cut, Wall Street is championing an IRA-type savings account, and there is even a tax credit for people who adopt. All worthy causes, yet each one further complicates an already arcane tax code and reduces the overall efficiency of the economy.

NO SMOKE AND MIRRORS

Better to simplify. Simplifying the tax code accomplishes two goals. First, it permits the markets to operate more sensibly—boosting growth and jobs—by removing government from the economic decisions of businesses and citizens. Income would be taxed at the same rate no matter what its source, and debt and consumption would no longer be encouraged. Second, tax simplification removes social engineering enacted through the tax system. Political choices become more transparent and accountable. The true cost of government programs becomes much clearer.

The logic of simplification has bred a raft of proposals, some better than others. The current favorite appears to be the radical single-rate flat tax of Representative Richard K. Armey (R-Tex.) that would levy one 17% tax on businesses and individuals, with no deductions or credits. Meanwhile, House Ways & Means Chairman Bill Archer (R-Tex.) favors a national sales tax, perhaps in the form of a value-added tax, which levies taxes on each stage of production. Then there is the more complex USA consumption tax designed by Senate Budget Committee Chairman Pete V. Domenici (R-N.M.) and Senator Sam Nunn (D-Ga.). A less radical Democratic proposal, a son-of-1986 Tax Reform, would close loopholes and lower all tax rates at the same time.

We favor a modified flat tax that would flatten the rate structure into two or three rates and preserve deductions for home mortgage interest contributions. Here's our thinking: Europe has had a VAT in place for decades, and it has become a bureaucratic nightmare, with exemptions that reflect all kinds of social-engineering policies—exactly what the U.S. wants to reverse. Since America already has an income tax infrastructure in place that people are accustomed to, it's more efficient to streamline it, use it, and not build another one. That way is just simpler.

We also favor making one big political compromise with economic efficiency by allowing deductions for mortgage interest to stand. It is politically unrealistic to believe that Congress would end this deduction for middle-class homeowners. And estimates of the possible loss from fully eliminating the deduction range as high as 15% to 20% of the value of the nation's homes. That adds up to a loss of up to $1 trillion in householders' net worth, the main source of personal savings. These amount to strong arguments for keeping the mortgage deduction but capping the deductible amount of the mortgage at $200,000. Totally eliminating the mortgage deduction would be highly deflationary, not only in terms of actual asset values but psychologically as well.

FOUND MONEY

The flat tax is also economically neutral, while consumption taxes along the lines of the Nunn-Domenici bill favor investment. The tax system should favor nothing. Better to let individuals and families decide how they want to spend their earnings and let the markets determine investment flows.

Finally, by using two or three rates and exempting incomes of, say, up to $36,000 for a family of four, a flat tax can be designed so that it doesn't fall too heavily on the poor. All flatteners agree that the poor should be totally exempt. In the 1980s, former Representative Jack Kemp (R-N.Y.) and former Senator Robert W. Kasten (D-Wis.) suggested a plan with two brackets—20% on wages and salaries and 25% on other income—that also preserved deductions for home mortgages and charitable contributions. Senator Bill Bradley (D-N.J.) and House Minority Leader Richard A. Gephardt (D-Mo.) came up with a plan with three brackets: 14%, 26%, and 30%. Both plans tried to lower the rates and broaden the tax base while making the tax system more neutral than it is now.

The U.S. was headed in the right direction under Ronald Reagan with the Tax Reform Act of 1986. Unfortunately, policy reverted under both Republican and Democratic Administrations. Tax simplification is an economic and social benefit. It's a wonderful chance to do three things: promote growth while cutting the government, permit individuals and businesses to make economically clean decisions, and give back to Americans billions of hours and tens of billions of dollars that they would otherwise spend on preparing their taxes. Now, that's a sweet springtime thought, isn't it?

In Trade Talks, a Duel of Statistics

Common Ground Is Hard to Find

By ANDREW POLLACK

TOKYO, June 15 — Anyone who wonders why Washington and Tokyo can't reach an agreement on automobile trade should try to answer these three questions:

1. The number of car models sold by American auto makers in Japan with the steering wheel on the right side, which is the custom in Japan, is
   (a) 59
   (b) 2?
2. America's trade deficit with Japan in autos and auto parts is
   (a) getting bigger
   (b) getting smaller?
3. Imported cars account for
   (a) only 4 percent of the Japanese market, far less than the imported share in other industrialized nations
   (b) 8-12 percent of the Japanese market, about the same as in other industrialized nations?

The correct answers are *a* or *b*, depending on whether one believes the United States Government or the Japanese Government. In other words, the sides are worlds apart, giving new meaning to the old saw about "lies, damn lies and statistics."

In an effort to influence world opinion, both Governments have been issuing a blizzard of statistical fact sheets and counter-fact sheets in a duel that has no doubt kept lower-level bureaucrats on both sides of the Pacific toiling over their spreadsheets until the wee hours of the morning.

Needless to say, each side presents the figures in a way that best suits its case.

Take right-hand drive cars. Japan argues that one reason so few American cars are sold here is that Detroit simply does not make cars for the Japanese market. It argues that there just two American cars sold in Japan with the steering wheel on the right side — the Chrysler Jeep Cherokee and the Ford Probe.

No way, cries Washington. The Government says there are 59 right-hand drive models offered in Japan by Detroit's Big Three, and it has published a list of them. (In fact, the list contains 60 models, but who's counting?)

The discrepancy is that Japan counts only cars made by the Big Three in the United States. Washington, however, includes cars made by **General Motors** and **Ford Motor** in Europe as well as those made by **Mazda Motors** in Japan that are sold here by Ford. It does not matter where the cars are made, Washington argues, as long as the models with right-side drive are for sale in Japan.

But Washington's view of what constitutes a car "model" is considerably more liberal than Japan's. Consider the Telstar sold by Ford and made by Mazda.

Washington lists 16 versions of the small car and counts each one as a right-hand drive model. There's the Ford Telstar II (18i-Ef) and the Telstar II (18i-E) and the Telstar II (18i-X), for example, not to mention the popular Telstar II (20i-X), which also comes in a four-wheel-drive version. There are also two models of the Telstar TX 5, two versions of the Telstar Sedan and seven varieties of the Telstar Wagon.

What is the difference, say, between the Telstar II (18i-Ef) and the (18i-E)? According to one Ford dealer, the E has an audio system and electrically retractable side-view mirrors, while the Ef does not. In other words, not much of a difference if all one cares about is which side the steering wheel is on.

Then there is the question of just how many new cars are sold by foreign auto makers in Japan. Washington argues that imported cars make up only 4 percent of the Japanese market; Japan says foreign auto makers captured more than 8 percent of the market last year.

In calculating import market share, the United States calculates imports as a share of *all* vehicles sold in Japan. Japan, however, counts only passenger cars, excluding commercial vehicles and minicars, arguing that foreign auto makers do not really compete in those segments.

Whatever the figure, how does this compare with other countries? Imports account for between 33 percent of the market in the United States and 55 percent in Italy. Given the paltry 4 percent share held by imports in Japan, that proves that Japan's market is effectively closed, Americans say.

Japan begs to differ. The share held by imports in other big car markets around the world ranges from only 5 to 16 percent, Japan says, not 33 to 55 percent.

As for the other nations, Japan excludes imports into the United States from Canada and Mexico and imports into one European country from another, arguing that these occur within free trade areas. That knocks down the share of the market held by imported cars in France, say, from the 38 percent calculated by Washington to only 5 percent.

What about the big picture? Can the two sides agree on that?

The question of whether the United States deficit in auto-related trade with Japan is getting bigger or smaller simply depends on which currency is used to measure it.

In dollar terms, the difference between imports and exports of automobiles and parts rose to $36.7 billion last year from $30.8 billion in 1990. But in Japanese yen, the deficit shrunk 13.4 percent during that period, mainly because Japan has been exporting fewer cars to the United States. But because the yen has substantially risen in value against the dollar, the deficit measured in dollars has climbed substantially.

As for the huge imbalance in auto parts pouring into the United States and the trickle of American parts flowing to Japan, Washington argues that something must be amiss in Japan because the United States has a surplus in auto-parts trade with the rest of the world.

Well, not quite, says Japan. Tokyo says the United States imports more parts than it exports with most countries, including Mexico, Germany and France. The overall surplus the United States crows about is mainly with Canada, Japan says, where the Big Three have several assembly plants that they supply with parts from the United States.

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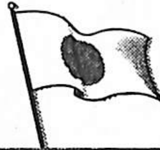
Point, Counterpoint

Each side of the dispute between the United States and Japan over automotive trade can rattle off trade statistics that support its case. How can both sides' figures be right? Through subtle differences in what they count and how they count it. Here are a few examples of the antagonists' contradictory spins.

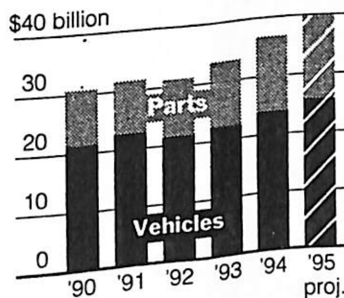
American View



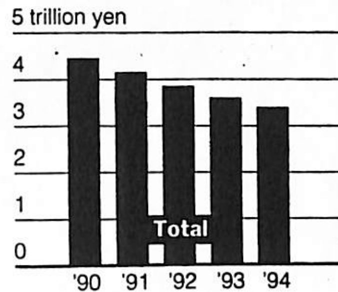
Japanese View

AUTO TRADE BALANCE

The United States's deficit with Japan in automobiles and parts is **growing** in dollar terms.

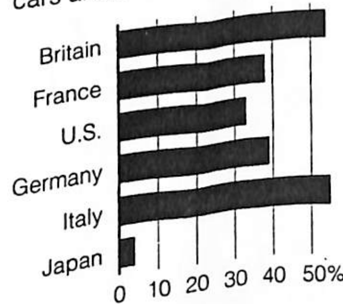


The United States's deficit with Japan in automobiles and parts is **shrinking** in yen terms.

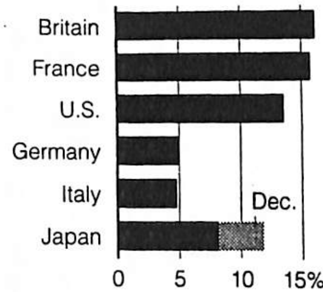


IMPORT PENETRATION

Imports' 1994 share of vehicle sales in Japan, including all cars and trucks, is **tiny.**

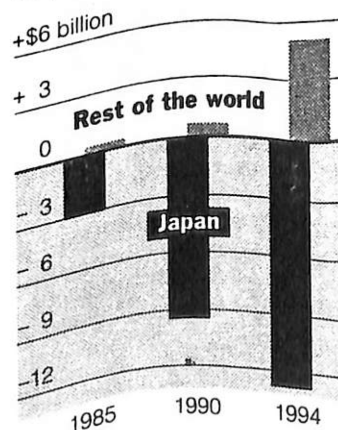


Imports' 1994 share of car sales in Japan, excluding mini-cars, is **about average.**

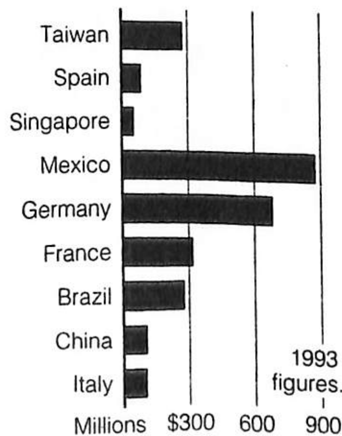


TRADE IN AUTO PARTS

The United States's deficit with Japan is **inconsistent** with its surplus with other countries.



The deficit with Japan is **not unusual**; the United States runs deficits with many countries.



Sources: Japanese Ministry of International Trade and Industry; United States Government agencies

The New York Times

FYI

Professor Barbara Jordan, Chair
U.S. Commission on Immigration Reform

On behalf of the Commission on Immigration Reform, I am pleased to summarize our interim recommendations on legal immigration reform. Let me note that these recommendations were unanimously or near unanimously adopted by our bipartisan Commission.

The Commission has concluded that a properly regulated system of legal immigration is in the national interest of the United States. Such a system enhances the benefits of immigration while protecting against potential harms.

Immigrants admitted through a well-regulated system strengthen the United States by creating economic opportunities, increasing America's scientific and cultural resources, strengthening our ties with other nations, fulfilling humanitarian commitments, and supporting family ties and family values that are so necessary to build strong communities. Further, our immigrant tradition demonstrates to the world that religious and ethnic diversity are compatible with national civic unity in a democratic and free country.

We recognize, however, that there are costs as well as benefits to legal immigration. Some of these costs are associated with the impact of immigrants on the localities to which they migrate in disproportionately large numbers. When immigrants are less well educated and less skilled, they may pose economic hardships for the most vulnerable of Americans, particularly those who are unemployed or underemployed. Immigrants sometimes utilize public services disproportionately, as in the case of elderly immigrants.

The Commission believes that the basic framework of our current immigration policy is sound. However, the Commission is also convinced that major reform is needed within this framework to ensure that admissions continue to serve our national interests. Hence, the Commission recommends a significant redefinition of priorities and a reallocation of existing admission numbers to fulfill more effectively the objectives of our immigration system.

To be specific, the Commission recommends a tripartite immigration policy that permits the entry of nuclear family members, professional and skilled workers, and refugees. We propose core immigration levels of 550,000 per year, with an additional 150,000 visas annually for the admission of the spouses and minor children of legal immigrants until the more than one million people in this category are admitted.

The Commission further recommends that admission levels be authorized by Congress for a specified time period in order to ensure regular periodic review and, if needed, change by Congress. The system we recommend should go into effect one year after passage of new legislation in order to permit a smooth transition.

With regard to family based immigration, the Commission emphasizes nuclear family. We recommend a priority system that ensures that the closest family members—spouses and minor children of citizens and legal immigrants and parents of citizens—are admitted as expeditiously as possible. It is not in the national interest of the United States for nuclear families to be separated for extended periods, as occurs under current law. In order to ensure the more expeditious admission of nuclear family members, the numbers that would have been used for the entry of other relatives should be reallocated to this higher priority.

The long waiting time for spouses and minor children is principally the result of the 1986 law that gave legal status to those who had been here illegally. This backlog, unlike others in the immigration system, is a one-time phenomenon and not something likely to be recreated after backlog clearance. Earlier this year I testified before both Houses of Congress urging the completion of the work of the Immigration Reform and Control Act with regards to employer sanctions—to adopt the tough policies needed to verify employment authorization. Now, I ask Congress to complete the other unfinished work of IRCA—to bring to a proper end the legalization program and to do so in a way that does not undermine the rest of our legal immigration system.

With respect to skills based immigration, the Commission remains convinced that immigration supports a national interest in helping U.S. businesses compete in the global economy. This national interest must be balanced by an equally compelling national interest in developing an American workforce with the skills to compete.

I am not arguing here for protectionism per se. U.S. workers with the education and skills that our universities provide need no protection from foreign competition beyond a level playing field.

What the Commission is concerned about are the unskilled workers in our society. In an age in which unskilled workers have far too few opportunities opened to them, and in which welfare reform will require thousands more to find jobs, the Commission sees no justification to the continued entry of unskilled foreign workers -- unless the rationale for their admission otherwise serves a significant national interest, as does the admission of nuclear family members and refugees.

Under the Commission's recommendations, then, professionals with at least a

baccalaureate degree and skilled, experienced workers would qualify. Unskilled workers would not be admitted for employment purposes.

Most foreign workers would be subject to a labor market test to ensure that American workers do not face unfair competition. The labor market test we envision would work on market principles rather than tedious, lengthy and costly bureaucratic procedures. Employers would be required to make a substantial financial investment into a private sector initiative that would be dedicated to the education and training of U.S. workers.

A smaller number of foreign workers who serve particular national interests would be exempt from the labor market test. For example, executives and managers of international businesses help the U.S. compete in a global economy. Immigrant entrepreneurs generate a significant number of jobs in the U.S. when they invest in new commercial enterprises. Individuals of extraordinary ability benefit the sciences, arts, education, business and athletics.

The Commission is still analyzing our system for temporary admissions and will have more to say on temporary workers and foreign students at a later date. We have come to firm conclusions, however, on one aspect of our temporary worker policy: The Commission believes that a large-scale agriculture guestworker program, sometimes referred to as a revisiting of the "bracero agreement," is not in the national interest. We unanimously and strongly believe that such a program would be a grievous mistake.

Regarding refugee resettlement policy and other humanitarian admissions, the Commission strongly affirms that the United States should continue its commitment to resettle refugees. We also urge a rethinking of refugee priorities in the context of the

post Cold War era. We believe that 50,000 refugee admissions is an appropriate target, following the transition period recommended by the Commission. However, our policy must also be flexible enough to address the now unforeseen refugee crises that could emerge. If circumstances require additional resettlement, we should be able to exceed the 50,000 limit with appropriate Congressional oversight.

Let me turn now to the issue of Americanization. That term earned a bad reputation when used in the 1920s. Nevertheless, we find it the best way to describe what the Commission believes to be an essential part of immigration policy — the civic incorporation of newcomers. The United States is the most successful multiethnic nation in history. It has united immigrants and their descendants from all over the world around a commitment to democratic ideals and constitutional principles.

Naturalization is the most visible manifestation of Americanization.

I have spoken at some length with Commissioner Meissner about her commitment to naturalization. She has been pushing this issue within the government since she took on her responsibilities at INS. I applaud her resolve in this matter. She has reached out to the private sector to get their assistance in preparing legal immigrants for naturalization. Let me use this platform to do the same. I urge private industry, churches, community groups and individual volunteers to redouble their efforts to provide English language instruction and civics education to immigrants. I remind immigrants that they have a responsibility as well—to embrace the common core of the American civic culture, civic values and institutions.

At present, there is greater interest in naturalization than there is a capacity to act upon

this interest. Large backlogs must be overcome as quickly as possible so that the nation can benefit from the growing commitment of immigrants to become American citizens. Reducing processing time and backlogs for naturalization must be a strategic goal of the federal government—INS, the courts, and the Congress. At the same time, INS must maintain rigorous standards in processing applications.

To conclude, and if I may, to answer some of the critics of immigration who are calling for a drastic reduction in admissions — Cultural and religious diversity resulting from immigration does not pose a threat to the national interest as long as public policies meet the requirement of civic unity. We have benefited from immigration throughout our history, and I have every confidence we will continue to do so.

I would be pleased to answer your questions.

June 7, 1995

FACT SHEET
CIR RECOMMENDATIONS ON LEGAL IMMIGRATION

General Recommendations

The Commission recommends a tripartite immigration policy that permits the entry of nuclear family members, professional and skilled workers, and refugees. In addition, the Commission urges Congress to take steps to address the continued aftereffects of the 1986 Immigration Reform and Control Act that provided legal status to formerly illegal aliens [legalized aliens].

The Commission proposes a core immigration admissions level of 550,000 per year, to be divided as follows:

Nuclear family immigration	400,000
Skill-based immigration	100,000
Refugees	50,000

The Commission further recommends that Congress authorize 150,000 visas annually for the admission of the spouses and minor children of legal permanent residents who have been awaiting entry until such time as the backlog is eliminated.

The Commission recommends that admission levels be authorized by Congress for a specified time period (e.g., three to five years) in order to ensure regular periodic review and, if needed, change by Congress. These recommendations should go into effect one year after enactment in order to ensure a smooth transition.

Nuclear Family Immigration

The Commission recommends a prioritization of family relationships to determine who will be admitted through family-based immigration, with admission numbers going to those who are of the highest priority. Only to the extent that visas are available after the demand in higher priorities is met should visas be made available to lower priorities. Following this reasoning, the Commission further recommends:

- The spouses and minor children of U.S. citizens should continue to be admitted as the first priority. Also to be admitted under this priority are the small number of adult children dependent on U.S. citizen parents because of a mental or physical disability.

- Parents of U.S. citizens should be admitted as the second priority. Being mindful of the potential, negative impacts that the entry of parents may pose for the U.S. taxpayer if these individuals utilize the Supplemental Security Income and Medicaid and similar programs, the Commission believes that continued admission of parents should be contingent on a legally enforceable affidavit of support. Affidavit signers (petitioners and/or coguarantors) should provide:

  (1) Verifiable assurance that they indeed have the capacity to provide what may be a lifetime of financial support to the parent immigrants; and

  (2) Verifiable assurance of the purchase (either privately or through buying into Medicare which the government should provide at an actuarially fair price) of what may be lifetime health coverage for the parent immigrants.

- Third priority should be allocated to spouses and minor children of legal permanent residents [LPRs], and the small number of adult children dependent on LPR parents because of a mental or physical disability.

The Commission recommends sufficient additional numbers, on an interim basis, to eliminate the backlog in the family admission categories that remain within the new immigration system. The addition of 150,000 visas will permit the elimination of the regular LPR beneficiary backlog within three years and

the legalization beneficiary backlog in eight years.

The Commission recommends elimination of other family-based admission categories, including:

- Adult, unmarried sons and daughters of U.S. citizens;
- Adult, married sons and daughters of U.S. citizens;
- Adult unmarried sons and daughters of legal permanent residents, and;
- Siblings of U.S. citizens.

The Commission recommends that the Department of State implement its visa issuance system in a manner to ensure that all authorized family-based immigrant admission numbers are utilized each year. The Commission further recommends that the INA be amended to address better the "aging-out" problem of certain aliens, by establishing that a person entitled to status at the time a petition is approved shall continue to be entitled to that status, notwithstanding his or her age.

Skill-Based Immigration

The Commission recommends that the preferences for the admission of skill-based immigrants be reorganized to reflect two categories: those subject to a labor market test, which we would expect to be the norm; and those who, for significant, specific policy reasons should be exempt from such a labor market test.

- Exempt workers should include those individuals whose entry will generate economic growth and who hold no potential for undermining the employment prospects and remuneration of U.S. workers. The following individuals should be exempt:

  (1)(a) Individuals at the very top of their chosen field whose extraordinary ability in the sciences, arts, education, business, and athletics is demonstrated by sustained national or international acclaim and whose achievements have been recognized in the field through extensive documentation, or (b) individuals who have demonstrated the potential for extraordinary achievement in their chosen field through extensive documentation, including the testimony of appropriate, recognized experts.

  (2) Managers and executives of international businesses. Greater safeguards must be put in place to ensure that only bona fide international businesses benefit from this policy.

  (3) Entrepreneurs whose active investment in new commercial enterprises generate a significant number of jobs for American workers in the United States.

  (4) A limited number of individuals ordained by a religious denomination and other religious workers who have carried on the religious vocation abroad during the two years immediately preceding the application for admission and who are sponsored by a religious denomination having a bona fide nonprofit, religious organization in the United States.

- Foreign workers permitted to immigrate to the United States on the basis of an offer of permanent employment should include only those who have attained a baccalaureate or higher academic degree or those who are needed to fill jobs that require a high level of specific skills above the entry or journeyman level. All such offers of employment will be conditioned on an appropriate test of the domestic labor market to ensure that qualified American workers are not being displaced or otherwise disadvantaged by the employment of immigrants, unless that position qualifies for an exemption from the labor market test as defined above. These categories include:

  (1) Professionals with advanced degrees, including professors and researchers who do not

meet the definition of "extraordinary;"

(2) Professionals with baccalaureate degrees, and skilled workers with a minimum of five years of specialized work experience. The admission of entry-level professionals and skilled workers in particular should be strictly scrutinized to ensure that they will have no adverse effect on similarly qualified U.S. workers.

The Commission recommends the elimination of the admission of unskilled workers. We see little justification for admitting unskilled foreign workers into an economy that must find job opportunities for millions of unskilled U.S. workers.

The Commission believes that the following four elements are fundamental components of a timely and effective labor market test:

- To demonstrate the bona fide need for a foreign worker and to increase competitiveness of U.S. workers, an employer should be required to pay a substantial fee, that is, make a substantial financial investment into a certified private sector initiative dedicated to increasing the competitiveness of U.S. workers, for example, through education and training efforts. To ensure that the employer, and not the foreign worker, pays the fee, penalties should be imposed upon violators.
- The employer should demonstrate that it has engaged in appropriate attempts to find a qualified U.S. worker using normal company recruitment procedures that meet minimal industry-wide standards.
- The employer must pay wages that are at least 5 percent above the prevailing wage.
- The resulting permanent resident status so obtained should be conditional for a two-year period. Conditional status would be removed at the end of that period if the foreign worker is still employed by the same employer at the same or higher level and if the employer demonstrates that the prevailing wage has been paid. The foreign worker could obtain a waiver in situations where unanticipated circumstances, such as layoffs, business failure, or unfair labor practices occur. Penalties for fraud should be authorized.

To provide greater flexibility and allow for market adjustments, the Commission recommends that skill-based visas not used in a fiscal year be carried over to the next year's skill-based numbers.

Refugee Resettlement

The Commission strongly affirms that the United States should continue its commitment to resettle refugees as one of several elements of humanitarian protection for the persecuted. The Commission recommends that, on an interim basis:

- 50,000 admission numbers be allocated each year to the entry of refugees from overseas.
- In the case of an emergency, the President may authorize the admission of additional refugees upon certification of the emergency circumstances necessitating such action. The Congress may prevent the emergency admissions with a two-house veto of the Presidential action.
- Other than in emergency situations, any refugee admissions in excess of the 50,000 admission level can be authorized only on the affirmative act of Congress.

The Commission recommends a thorough assessment of the criteria used to admit refugees for resettlement. The Commission will issue specific recommendations— which may include modification of the interim recommendations above—on refugee resettlement in conjunction with the Commission's report on immigration emergencies scheduled for the end of 1995.

Nonimmigrant Admissions

The Commission believes that both immigrant and nonimmigrant admissions must be considered as part of an integrated immigration system. Although we are deferring specific recommendations on most nonimmigrant issues until we have completed a comprehensive review, we do note two areas of particular concern.

- The Commission intends to examine in depth the nonimmigrant temporary worker and foreign student systems and their relationships to permanent immigration.
- The Commission believes that an agriculture guestworker program, sometimes referred to as a revised "bracero " program, is not in the national interest and unanimously and strongly agrees that such a program would be a grievous mistake.

Americanization

The United States is one of the most successful multiethnic nations in history. It has united immigrants and their descendants from all over the world around a commitment to democratic ideals and constitutional principles. Naturalization is the most visible manifestation of such civic incorporation.

The Commission strongly recommends that INS adopt and implement as a strategic goal the reduction of processing time and backlogs for naturalization, while maintaining rigorous standards in processing applications. The Commission also urges Congress to appropriate sufficient resources out of the fees paid by naturalization applicants to support the implementation of this strategic goal.

The Commission urges INS to:

- Set a standard reasonable time frame for processing naturalization applications.
- Continue to recruit national and community-based organizations, both public and private, [as well as employers] to assist in the process of naturalization applications.
- Ensure that there are adequate numbers of personnel to complete naturalization processing efficiently.
- Carefully scrutinize the naturalization applications of all Special Agricultural Workers [SAW] applications to assure that their original SAW applications were properly granted.

The Commission urges both the public and private sectors to assist legal immigrants in their preparation for naturalization.

- The Commission urges private industry, churches, community groups and individual volunteers to redouble their efforts to provide English language instruction and civics education to immigrants.
- The Commission supports targeted outreach programs aimed at informing eligible immigrants about the requirements for naturalization.

WSJ 6/9/95 p. B4

Panel's Proposals to Slash Immigration Spur Intense Opposition of U.S. Business

By JOE DAVIDSON
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – Business leaders blasted a federal immigration commission's plan to cut the number of foreign workers allowed into the country, calling it hostile to U.S. global competitiveness.

"Recommending a reduction in the number of foreign workers U.S. companies can hire shows an ignorance of how business operates in today's global market," said Paul Huard, National Association of Manufacturers senior vice president.

The Commission on Immigration Reform recommended cutting legal immigration by one-third and reducing the number of business visas by 40,000, to 100,000. President Clinton has endorsed the proposals, saying they "reflect a balanced immigration policy that makes the most of our diversity while protecting the American work force so that we can better compete in the emerging global economy."

But those representing the international competitors disagree.

'Tax' Seen on Foreign Hires

Particularly upsetting to the business leaders is a plan to charge them for each foreign worker they hire. That fee, or "tax" as opponents calls it, would be a labor-market test to ensure that qualified American workers aren't displaced by immigrants.

"To demonstrate the bona fide need for a foreign worker and to increase competitiveness of U.S. workers, an employer should be required to pay a substantial fee" to a private-sector program for the education and training of American workers, according to a fact sheet from the commission. The amount of the fee hasn't yet been determined.

Furthermore, adds the commission's information, "the employer must pay [recruited foreign workers] wages that are at least 5% above the prevailing wage."

Reducing the number of business visas wouldn't really cut the number of foreign workers, because the current demand is less than the available slots, according to Susan Martin, the commission's executive director. Allowing entry of 100,000 skill-based immigrants actually represents a 10% increase from the actual number of visas used, she added.

But Phyllis Eisen, a NAM spokeswoman, says that even if that figure is true, it's irrelevant. Many more small and medium-size businesses are planning to enter the global marketplace and will need foreign workers. "We're suppose to be looking to the future, not backward," she said.

Motorola Aide Opposes

James Burge, corporate vice president of Motorola Inc., said that company "supports efforts to prevent unscrupulous employers from undercutting U.S. wages and working conditions by hiring foreign workers at cheap rates." But reducing immigration and charging a fee for those hired, he said, "will serve no purpose other than to obstruct our country's economic growth potential in a world market."

President Clinton said the proposals are consistent with his pro-family, pro-work views and called the recommendations a "road map for the Congress to consider." The road between the plan and congressional approval, however, promises to be a controversial one, as those favoring a more open immigration policy, including Asian-American and Hispanic members of Congress, fight the commission's initiatives.

Warren Leiden, a commission member who dissented from many of the recommendations, said the proposed fee is in particular trouble. "It's hard for me to believe the House of Representatives is going to approve a tax like this," he said.

Market Place | Floyd Norris

[J]apan's banks need shoring up if [i]ts stock market is to revive.

IT used to look like Japan had most of the money in the world and was doing a good job of gathering up the rest. Now its financial mar[k]ets are shaking because of fears the financial [f]abric of the country is unraveling.

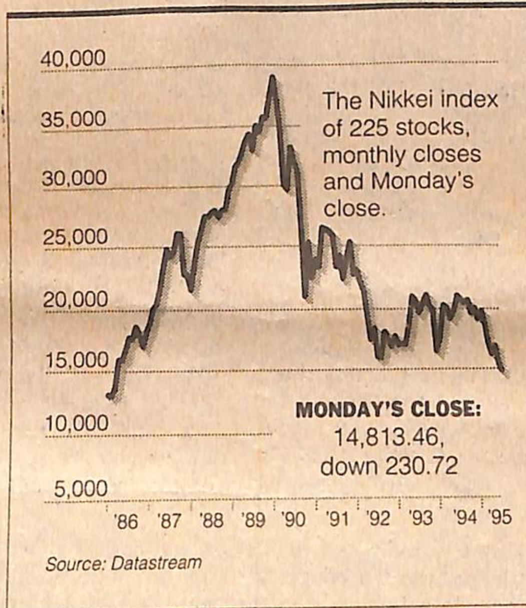
Worries about the Japanese banking system — [s]till heavily burdened with bad loans that were [m]ade to real estate speculators during the boom [y]ears — have helped produce the latest plunge in [J]apanese stocks. Share prices are nearing, or in [s]ome cases have already fallen below, the levels [r]eached in 1992, when it appeared that the market [h]ad reached bottom after a sharp fall.

Moreover, the selling is coming in part from [J]apanese insurance companies, which need in[c]ome to support the guaranteed returns they [p]romised to policyholders and have decided that [t]hey are unwilling to wait for capital gains on [s]tocks. The average Japanese stock pays less [t]han 1 percent in annual dividends. Last week [b]rought word that the insurers sold more stocks [i]n the first five months of this year than in all of [1]994.

That the worries are coming years after the Japanese stock market bubble burst is a testament to the belief that the Japanese Government would somehow stem the pain in the Japanese banking system. Those problems, however, have festered, and the apparent lack of a Government solution has been one cause of the latest decline. The Government released a plan last week that was meant to help the banks, but it was widely dismissed as being ineffective.

The Nikkei index of 225 stocks, the best-known indicator of major Japanese companies, has fallen 7 percent in the last five trading sessions and is down 25 percent since the end of 1994. At yesterday's close of 14,813.46, it is only 3.5 percent above the low of 14,309.41 reached in 1992. If it were to break through that level, it would be trading at its lowest levels since early 1986.

The Topix second section index, the leading index of smaller Japanese companies, fell just 6 percent over the five sessions, but it is down 32 percent for the year and has fallen through its 1992 low. At yesterday's close of 1,457.44, it was at its lowest level since Dec. 28, 1983.



The New York Times

For American holders of Japanese stocks, of course, some of the pain has been eliminated by the soaring yen. Measured in dollars, the Nikkei is down only 11 percent since the end of last year, and it remains well above its 1992 levels.

The short-term question confronting Tokyo is whether the Government will risk public anger and bail out banks that are in deep trouble but — thanks to their failure to write down bad loans made during the years of Japan's bubble — have not reflected that reality on their financial statements. Some argue that the Government is trying to prepare the public gradually for that, but investors do not seem to be impressed by such gradualism.

At the same time, Japanese investors are worried about the ability of the country's industry to make money with the yen as high as it is against the dollar. "There is simply no ability in the export sector to generate earnings," said Steven Nagourney, global strategist at Lehman Brothers. "What we have been going through is a realization that there is no excess earnings power in Japan," in large part because of the currency factor.

Robert Barbera, the chief economist of Capital Investments International, a New York advisory firm, argues that the stock market is also reflecting the impending decline of the country's huge trade surplus. Much of it, he says, is now coming from the export of capital equipment to allow production to be shifted to other countries with lower costs. And, he adds, there are signs that imports are finally beginning to penetrate the country as protectionist walls break down in some areas.

During the boom years, the stock market benefited from the interlocking relationships among companies, banks and insurance companies, all of which tended to own stock in one another. That helped to establish and protect various corporate relationships, including the close ties between auto parts suppliers and auto companies that have lately enraged the United States.

But it also meant that the real equity — shares held by outsiders — was relatively low in corporate Japan. Even when prices rose to unbelievable heights, Japanese companies were relatively restrained in selling new equity issues.

During the post-1992 revival, the Governmen[t] intervened to effectively block most issuance o[f] new shares, trying to avoid increasing the suppl[y] of stock when there was limited demand. It als[o] forced large investments in Japanese stocks b[y] public pension funds. Those investments now loo[k] like losers.

Bank stocks in recent days have fallen less tha[n] the market as a whole, and the Topix bank stoc[k] index is still above the lows it reached in Marc[h]. But that could change. Although the situatio[n] varies from bank to bank, it is a widely quote[d] rule of thumb in Tokyo that a fall of the Nikkei 22[5] below 14,000 would leave many banks with inade[-]quate capital as the value of their shareholding[s] declined. It will be interesting to see if the Gov[-]ernment is able to come up with more vigorou[s] action if that happens.

WSJ 6/6/95 p. A2

Sharp Decline in Job Stability Is Found In New Study, Contradicting Prior Data

By G. PASCAL ZACHARY
Staff Reporter of THE WALL STREET JOURNAL

Job stability declined sharply during the 1980s, according to a new federal study, contradicting a spate of recent economic studies that found little change in the length of employee tenure with the same employer.

The study, by the National Commission for Employment Policy, a government advisory panel, found that employees with "strong" job stability, defined as only one or no job changes in a 10-year period, decreased from 67% in the 1970s to 52% in the 1980s. The percentage of employees with "weak" stability, defined as those changing employers at least three times during a 10-year period, doubled to 24% during the 1980s. The study is to be released today.

"Why did I find a decline, when others didn't? The data I used are better for this particular issue," said Stephen Rose, the employment commission's chief economist.

Mr. Rose attributed his findings to the reliance on data collected by the University of Michigan's Panel Study on Income Dynamics. The Michigan panel surveys the same people over many years. Other economists, who have published papers on job stability over the past two years, have relied on survey data from the Census Bureau's Current Population Survey, which doesn't track the same respondents.

The question of job stability is crucial to evaluating downward mobility of workers, because workers who switch jobs frequently – whether voluntarily or not – are more likely to see wage declines and will have a harder time accumulating pension benefits. The perception of declining stability, fueled by the many mass layoffs in recent years, may explain why those with reasonably well-paying jobs lack confidence about their future – because they expect an interruption in their work lives.

Some other economists criticized Mr. Rose's findings, saying that while his approach was innovative his measures of stability may understate longevity.

After reviewing the study, David Neumark, an economics professor at Michigan State Univerisity, found that Mr. Rose's measures were "real sensitive to short job tenure and less sensitive to longer tenure," because they don't make any distinction between employees with 10 years tenure and those with, say, 12 years.

The study also finds the biggest decline in stability for men in their prime-working years. The finding is consistent with earlier studies that, while finding overall job stability steady, have reported a drop in the stability of male employees.

Mr. Rose's findings don't "cast any fundamental doubt on my work," said Henry Farber, a professor of industrial relations at Princeton University who released a study in February that showed no overall decline in job stability.

Mr. Rose contended that other economists are too sanguine in their assessment of job stability and criticized their reliance on Census Bureau survey data. He noted that respondents have a natural impulse to play down turbulence in their lives and that the crucial question about job stability in the Census Bureau survey was altered during the 1980s, a shift that might account for an inflated degree of stability.

"That could inject bias," Mr. Farber said, "but I don't think that's driving my results."

The cost of inflation

No sensible policy-maker questions the view that inflation is a bad thing—not in public, anyway. Since financial markets are always listening, any thinking aloud on the subject is likely to be punished. Despite this, the evidence that inflation hurts economies is far from overwhelming

ECONOMICS FOCUS

ECONOMISTS have spent a lot of effort trying to measure the effect of inflation on economic growth. Many governments would be grateful for clear evidence that it slows growth a lot: this would make it easier for them to justify the usually painful policies that are needed to bring inflation down. But the evidence, such as it is, is none too clear.

Theory points confidently to the view that inflation (especially the unanticipated kind) hampers growth. It inevitably causes uncertainty about future prices; this in turn will affect decisions about spending, saving and investment, causing resources to be misallocated. Inflation has other costs too. It may cause substantial redistributions of income and wealth—notably from savers to borrowers. And if it discourages saving in this way too, then investment and growth are likely to suffer all the more.

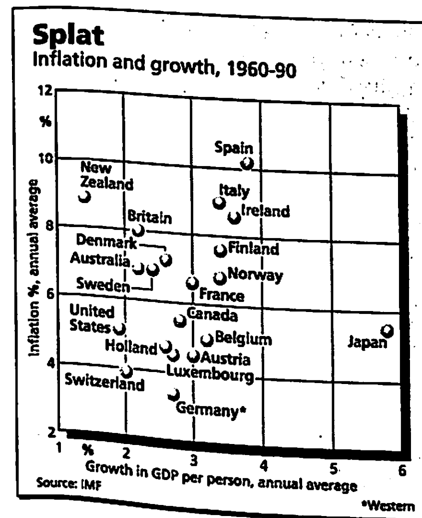
However, the statistical evidence is less clear-cut. A scatter-plot of inflation against growth for a range of countries is a meaningless jumble (see chart). It is always possible to draw a crude line-of-best-fit through such data: depending sensitively on the choice of period, it would slope downwards (indicating that high inflation is bad for growth) or upwards (indicating the opposite). By itself, information on inflation and growth suggests no straightforward connection between the two. Which poses the question whether governments and financial markets take inflation too seriously.

Before deciding that they do, note that raw information on inflation and growth is no use at all. The scatter-diagram ignores the many other factors that affect growth and/or inflation. The task of econometrics is to strip away these other factors so that the true connection, if any, between the two can be seen. Needless to say, this stripping is extremely difficult. There is no end to the list of factors, other than inflation, that might plausibly be said to affect growth (and which thus have to be filtered out). There is no single "right" way to do this—rather, lots of different ways, producing a confusingly wide range of estimates.

The most recent estimate has attracted attention in Britain in a way its author probably regrets. The Bank of England's new *Quarterly Bulletin* carries an article by Robert Barro, a distinguished professor of economics from Harvard, currently visiting the Bank. Reporters seeking the largest measure of discomfiture for the authorities wrote (incorrectly) that the article proved inflation to be harmless. In a week when the government and the Bank were being criticised for their handling of interest-rate policy (see page 55), this was an unwelcome extra embarrassment.

How small is harmless?

Mr Barro's study takes care to avoid the standard pitfalls. One of these is the short-term cyclical connection between growth and inflation: both tend to rise in booms and fall in slumps. In an analysis that examines the connection between growth and inflation year by year, this may obscure the longer-term relationship (if any). Mr Barro deals with this by looking at inflation and growth over a single period of 30 years, from 1960 to 1990, comparing more than 100 countries, rich and poor.



Next, to take account of the other factors that affect growth, Mr Barro posits inflation as just one of many explanatory variables in his statistical model of growth. The others are initial incomes, educational attainment and life expectancy; aggregate government spending; government spending on education; indexes to capture some price distortions, the extent of the rule of law and democratic rights; investment; and fertility.

Mr Barro also allows for the possibility that causation may not run directly from inflation to growth. Instead, each may be jointly influenced by some other variable, or causation could run in the opposite direction, from growth to inflation. He explores these channels of cause and effect by using "instrumental variables"—a statistical technique that looks for changes in inflation caused by factors outside the model, and asks what affect these "exogenous" changes have on growth.

Mr Barro duly crunches his numbers—and finds that an increase in inflation of one percentage point reduces the rate of economic growth by between 0.02 and 0.03 of a percentage point each year. This may not be "harmless", but nor is it exactly earth-shattering. On these estimates, a country with an inflation rate of 100% a year is sacrificing between two and three percentage points of economic growth: a huge amount. But a country that reduced its inflation rate from, say, 7% to 2% would see its growth rise by only a little more than one-tenth of a percentage point. Since reducing inflation is itself costly—it demands a (temporary) loss of output and jobs—governments that took Mr Barro's numbers seriously would be forgiven for wondering whether that price was not often too high.

Possibly out of courtesy to his hosts, Mr Barro is careful in his summing up. "The magnitudes . . . are not that large . . . Over long periods, however, an apparently small change in the average growth rate has dramatic effects on standards of living." His estimates are "more than enough to justify the Bank of England's keen interest in price stability."

Two other points may better justify the Bank's keen interest. One is that Mr Barro's estimates are at the low end of the range established in previous work. Other reputable studies, using rival methodologies and data-sets, have produced estimates of the effect of inflation on growth that are five and ten times greater than Mr Barro's.

Remember also that the authorities' mandate to fight inflation was not granted by a bunch of economists but, in just about every country where electorates have a say, by voters. Inflation is unpopular. This is not mainly, if at all, because people believe that it hinders economic growth. Rather, inflation is disliked in its own right. That is why few politicians expect to win votes these days by promising to be soft on it—and another reason why Mr Barro's findings call for no urgent reappraisal of any sensible government's economic aims.

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FACSIMILE TRANSMISSION

To:	**Anwar Shaikh**	**From:**	**Jon Cracknell**
Co:	**Jerome Levy Economics Institute**	**Date:**	**18 May 1995**
Fax No:	**001 914 758 1149**	**Pages:**	15
c.c:			

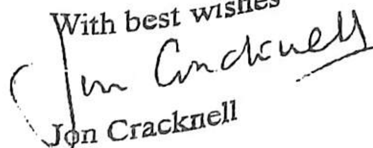
Dear Mr. Shaikh

Thank you very much indeed for replying so fully and quickly to my phone calls on Tuesday. I very much appreciate the time you took to explain how you arrived at the productivity and wage figures for Mexico and the U.S. As it happens I also have a copy of the World Bank's *World Tables*, and I was also struck by the fact that the US data finish in 1987. A few months ago I plotted the US data over the years from 1977 to 1987, in order to compare them with data on manufacturing productivity supplied by the Bureau of Labor Statistics at the Department of Labor. I was surprised to find a divergence between the two series, (as I assumed that the World Bank would simply be re-publishing data from the US government). When I asked the BLS what accounted for the difference, they sent me some information on the way in which the National Income and Product Accounts are calculated, and there seems to be a different approach used in the two sets of figures.

Yesterday in conversation with the BLS I discovered the full range of productivity indicators which they publish for the US economy (e.g. for the business sector as a whole, the non-farm business sector, the manufacturing sector, non-financial corporations etc). I was trying to find a good fit between data on the decline in real weekly wages of "production and non-supervisory workers" (some 19.2% over the period 1973 to 1993), and increases in productivity. I came to the conclusion that none of the productivity indicators fitted perfectly with the production and non-supervisory worker category, but that it would be defensible to use either the measure for the whole business sector, or that for non-financial corporations. The respective increases in productivity over the years 1973 to 1993 are 23.2% or 28.4%.

The question of the relationship between real wages and productivity is discussed in the Economic Policy Institute's recent book, *The State of Working America*. I have attached some pages from their chapter on wages which I thought might be of interest to you.

With best wishes



Jon Cracknell

WSJ 5/22/95 p. A7D

Repeal of Alternative Minimum Tax Stirs Big Business Backers, Opponents

By LUCINDA HARPER
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON—Corporations weren't satisfied with the hefty tax breaks they saw in the Republicans' Contract With America, so they lobbied and got one more — an exemption from paying any taxes at all.

Their focus is the alternative minimum tax, created in 1986 to make sure all companies pay some corporate income tax, no matter how many deductions or credits they claim. Firms that invest heavily in capital equipment have long disliked this requirement. They say the AMT puts extra burden on them by limiting depreciation write-offs.

"We were struck by how many companies said: 'If you really want to do something for big business, repeal the AMT,' " recalls Ari Fleischer, spokesman for Congressman Bill Archer, who added its repeal to the Republican contract after the initial tax breaks had been introduced. The entire tax bill was approved by the House and awaits Senate action.

"The tax is unfair," says **AlliedSignal** Inc. Chief Executive Lawrence Bossidy. "It penalizes steel companies and those with heavy capital equipment. Hence, there is strong support for its repeal."

To Fight 'Corporate Freeloaders'

Not everyone agrees. The alternative tax was created amidst outrage from citizen groups who said that profitable companies should pay some federal taxes even if the many available deductions meant they technically owed none. Robert McIntyre, director of Citizens for Tax Justice and leader of the fight, says the AMT has helped eliminate "no-tax corporate freeloaders" who "engage in a plethora of economically wasteful tax-avoidance activities."

Here's how the AMT works: Most companies pay the 35% regular corporate tax rate on their profits, minus any amounts sheltered by such tax deductions as depreciation. Alternatively, companies must pay a 20% minimum tax on profits as computed without some of the deductions, if the AMT is higher.

AMT taxable income is often higher than regular taxable income because depreciation write-offs, for example, are applied less quickly under AMT provisions. Another reason is that investments in mining exploration and development must be depreciated over 10 years rather than immediately.

Such differences explain why affected companies want the AMT repealed. Thomas Usher, chief operating officer of USX Corp., says the tax is "pernicious," "harmful" and puts manufacturing firms at a "severe competitive disadvantage."

But the Internal Revenue Service says only a few companies actually pay the AMT. According to its figures, the AMT affected only 28,000 corporations a year between 1987 and 1991 — about 1.2% of all corporate filers.

Despite this small number, repealing the alternative minimum tax would be expensive for the U.S. government. Treasury assistant secretary for tax policy Leslie B. Samuels estimates that in the year 2005, when repeal would take full effect if passed into law, 76,000 companies could then avoid taxes. These companies represent 18% of all corporate assets, according to the Treasury.

For example, in 1992 **Texas Utilities** paid $19.6 million in federal income taxes on more than $1 billion in profit. Without the AMT, the utility company would have actually received a tax rebate of $18 million, Mr. McIntyre says.

Packwood's Rationale

Even Senator Bob Packwood, chairman of the Senate Finance Committee, has reservations about repealing the minimum tax requirement. "We cannot return to the days where people of immense wealth pay no taxes at all," he says.

Hank Gutman, partner at **King & Spalding** and former chief of staff of the Joint Committee on Taxation, says the problem is that the U.S. tax system allows companies to zero out at all. "The code should be made so that everyone pays a tax without an AMT," he says.

Still, others say the AMT is the best thing available to make sure profitable firms pay something. "The basic principle for which it was established is valid today," says Yale law school professor Michael Graetz, "even though there may be problems with it."

NYT D1 5-2-95 D7

The Woes of a Weak Dollar

What's Good for Exporters Isn't Good for Everyone

By LOUIS UCHITELLE

For all the advantage to exporters in this country, the sharp decline of the dollar in recent months is beginning to hurt American companies in their efforts to expand abroad. It also threatens to reverse the gains they have made against foreign competitors in the last decade.

Companies looking to raise their presence abroad through acquisitions are finding the price increasingly prohibitive. Consider the Wall Street financier Sanford I. Weill's ill-fated bid for the brokerage arm of Barings P.L.C., the insolvent British investment bank. Mr. Weill traveled to London in March to negotiate the acquisition, only to watch as "the value of our bid fell by 4 percent in a single week." The Dutch firm ING, bidding in strong guilders, won.

Or consider Stephen R. Hardis, vice chairman of the Eaton Corporation of Cleveland, who reluctantly canceled an expansion strategy that American multinationals have pursued for years. Eaton wanted to buy a big German company to manufacture its electrical controls and auto parts. But the falling dollar made such a purchase too costly. "We will have to expand in Germany slowly, through exports," Mr. Hardis said. "That is far less effective than having a local presence."

Closer to home, some voices are warning that the enfeeblement of the dollar might undo much of the cost-cutting that has been the guiding principle of corporate America for more than a decade.

Stephen S. Roach, chief economist at Morgan Stanley & Company, thinks 1995 could be as much a turning point for corporate America as 1985. In that year, the resurgent dollar peaked at more than 3 marks and 250 yen, crimping American sales overseas. Finding themselves underpriced by their European and Japanese competitors, American companies stepped up a restructuring binge — cutting costs, shifting production abroad and holding back wages.

Today, with the dollar at 1.39 marks and about 83 yen, the situation may be reversing itself, Mr. Roach warned. The dollar's battering is lulling corporate managers "into a false sense of complacency that allows them to take their eye off the ball in the global contest for market share," he said.

"Under the protective umbrella of a weak dollar," Mr. Roach added, "there's the chance that businesses could finally become lax in granting wage increases to increasingly disgruntled and overworked labor forces. Such a trend would be particularly disconcerting, since so many union contracts are up for renegotiation this year."

The falling dollar has raised that very thought in the mind of Joseph Uehlein, an A.F.L.-C.I.O. official. "It is becoming a very good reason to demand wage increases in contract talks this year, especially in view of the concessions that were granted in the name of making companies more competitive," he said.

With the exception of its surge in the early 1980's, the dollar has been gradually falling for decades against the yen and the mark, the world's two other most powerful currencies. But no one anticipated the latest plunge, to so low a level. The conventional wisdom still holds that a weak dollar can help the American economy by making American goods more affordable for foreigners, spurring exports.

The dollar's weakness has indeed increased sales abroad for American manufacturers. What's more, the nation's big multinationals have found ways to insulate themselves from currency swings. Over the last decade, many have set up or expanded operations abroad, and now their new foreign revenues offset the decline in the dollar. A thousand yen earned by Motorola's operations in Japan, for example, were worth $10 in January and $12 yesterday.

> ***'Exports are rising but that won't last,' says a company president.***

What is getting less attention are the negatives. For example, as foreign-currency fees to register patents overseas have risen, some companies have cut back. They have reduced the number of countries where they pay for such protection to keep their products from being illegally copied and sold, said George Gottlieb, a patent attorney. "My clients are pruning their portfolios," he said.

Even people who should be rejoicing at the export opportunities are gloomy. The **Will-Burt** Company, an Orrville, Ohio, maker of vehicle parts, is too small to set up its own manufacturing plants overseas. But exports to Europe of its rotating lights for emergency vehicles are booming as the low dollar makes them cheaper in other currencies. Will-Burt is also getting more orders from **Caterpillar** Inc. because the American heavy-equipment maker's overseas sales are rising as it takes customers away from its big Japanese rival, **Komatsu**.

Yet far from exulting, Harry E. Featherstone, Will-Burt's president, is nervous. "Exports are rising but that won't last," he said. "I've been in manufacturing 45 years, and I have finally learned that when the dollar falls, something goes wrong. This opportunity for more exports is going to turn out to be temporary, even if the dollar stays down."

Other companies, having spread their operations abroad to protect themselves from currency fluctuations, are now reluctant to shift them back home to take advantage of the weak dollar. **Intel** and **AT&T**, for example, buy parts from Japanese suppliers that might now be made more inexpensively in the United States. But neither company plans to switch to domestic production.

"If the dollar stays weak, there will be some migrating of production back to the United States, but only on the margin," said Lawrence Seifert, AT&T's vice president for global manufacturing. "We have been through this currency problem so much that we are more or less deployed globally, and that will not change."

Even so, many economists think the dollar should rebound. "You cannot sustain a situation in which 83 yen, the dollar's value today, will buy

twice as much in Tokyo — twice as much coffee, for example — as a single dollar will buy in New York," said Milton Friedman, the Nobel laureate in economic sciences. By his reckoning, a dollar's true value is more than 150 yen, and therefore must inevitably return to that level, last reached in 1990.

"The dollar is not weak," Mr. Friedman said. "It is just that the Japanese and Germans are out of line."

The latest plunge of nearly 20 percent against the yen and 12 percent against the mark is sorely testing such an assumption. The dollar is showing no signs of recovering to its 1994 levels. And Paul A. Volcker, the former chairman of the Federal Reserve System whose anti-inflationary efforts reversed the dollar's decline in the early 1980's, wonders if it will.

"We have dug ourselves a kind of hole that we can no longer easily get out of because the implicit confidence that everyone had in the dollar, which has been amazing, has eroded and it is a real challenge to restore it," Mr. Volcker said. "If you think American leadership is important, that erosion is a negative."

Mr. Volcker and other experts tick off reasons why they think the dollar won't recover. People overseas have accumulated hundreds of billions of dollars, particularly since the 1980's, and the outflow is worsening, reducing the dollar's allure. Most of the imbalance results from the chronic trade deficit.

More recently, another big exodus of dollars has begun. Mutual funds, insurance companies, speculators

'The Japanese and Germans are out of line,' says Milton Friedman.

and pension funds, which once confined their activities largely to the United States, are investing billions in foreign stocks and bonds.

The cold war, previously a major reason to hold dollars, is gone. The Japanese, once enthusiastic investors in America, are trying to liquidate holdings and convert their dollars to yen, to rescue a struggling economy back home. And American interest rates, which used to be much higher than rates in Japan and Europe, are closer now, so the incentive for foreigners to invest in American securities is diminished.

"You have all this money out there, in reluctant hands, and $1 billion more going out every business day," Mr. Volcker said, "and sometimes there are people out there who will buy that many dollars and sometimes there aren't. It gives a constant weak tinge to the dollar."

In the War of Politics, Medicare Spending Has Become

By DAVID E. ROSENBAUM

WASHINGTON, May 1 — Republicans and Democrats are at war again over Medicare.

The back and forth of the last few days has largely been political positioning. But it shrouds some serious substantive decisions facing the President and Congress that could significantly affect the medical insurance available to 40 million elderly and disabled Americans.

News Analysis

To separate the facts from the political claims and counterclaims, it is important to keep these points in mind:

¶As a practical matter, the Federal budget cannot be balanced in seven years, as the Republicans promise, without deep cuts in projected spending for Medicare.

¶Cuts of this magnitude would raise the cost of health insurance to millions of retirees (read "voters") or reduce the services available to them.

¶The Medicare trust fund that finances hospital bills is again in danger of running out of money. The problem has recurred periodically over the last quarter century, and Presidents and Congress have managed to resolve it without undermining the program.

¶Democrats have scored politically in the last few weeks with their argument that the Republicans' Medicare plan would pay for tax cuts for the wealthy. The proposal by Senator Bob Dole and Speaker Newt Gingrich to remove Medicare from the debate over the budget is largely an effort to gain more solid political footing.

Take these points one by one.

BALANCED BUDGET. Along with Medicaid, the health program for the poor, Medicare is the fastest growing part of the Federal budget. It will cost $176 billion this year and, unless changes are made, $286 billion in the year 2000, a 62 percent rise.

The Republicans in Congress have promised not to touch Social Security or lower the military budget, and interest on the national debt must be paid. Medicare is nearly 25 percent of everything that is left, and the fraction is growing every year.

In trying to write a balanced budget by 2002, Republican leaders have talked about reducing Medicare spending an average of $35 billion to $45 billion a year over the next seven years, although they have not said what steps they would to achieve that saving. This is one-quarter to one-third of the total saving required if the budget is to be balanced without raising taxes.

"Realistically, there is no way to come close to balancing the budget without cutting Medicare," said Stanley E. Collender, director of Federal budget policy at Price Waterhouse, the accounting firm.

> Vying for the high ground with a vast number of votes at stake.

PAINFUL CUTS. Trying to show that reducing projected spending for Medicare would not require a great deal of sacrifice, Republicans have made two main arguments. The first is that easy savings could be accomplished by placing Medicare beneficiaries in the kind of cost-efficient managed care programs now used by a majority of American workers. The second is that under the Republican plans, spending would continue to rise; only the rate of growth would be restricted.

Most independent analysts of the situation take issue with both arguments and say that limiting Medicare spending would inevitably result in higher costs or reduced benefits for the elderly.

In the case of managed care, little evidence exists to suggest that quick savings could be achieved in an elderly population requiring much more expensive medical treatment than people of working age.

Robert D. Reischauer, the former director of the Congressional Budget Office and now a senior fellow at the Brookings Institution, made the point this way: "There is some hope that managed care might save money, but not in the next few years. Managed care involves structural changes that take time to implement, and it requires a marketing campaign to convince beneficiaries that it is in their interest. That will take a long time."

Mr. Reischauer's analyses of health costs were eagerly embraced by Republicans last year when he calculated that the Clinton health plan would cost much more than the Administration had estimated.

As for restricting only the rate of growth in spending, the rising Medicare costs now being projected reflect not an expansion of the program but rather overall inflation in health costs and an increase in the size of the population entitled to benefits under the program.

An analogy can be seen in the military budget. The Pentagon spent the same amount — $282 billion — in 1987, before the end of the cold war, and in 1994, but no one seriously argues that the military budget has not been cut. By last year, for example, the number of troops had declined to 1.6 million from 2.2 million and the number of Navy fighting ships to 387 from 568.

TRUST FUND. In an effort to shift the emphasis away from the idea of cutting Medicare to balance the budget, Republicans have begun to argue that savings are needed to keep the system from going bankrupt.

Unlike doctor bills, which are covered by general tax revenues and premiums paid by the elderly, hospital bills covered by Medicare are financed by a 2.9 percent payroll tax divided equally between employers and employees. This money goes into a part of the budget called the Health Insurance Trust Fund, and by law, this is the only money that is to be used to pay those Medicare expenses.

For years, the fund has run a surplus. The extra money has been used to buy Government securities, thus reducing the amount the Treasury was forced to borrow in the private economy. But beginning next year, the tax revenues and interest received on the securities will be less than the amount paid out for health care. By 2002, the fund's trustees estimate, the fund will have run dry.

A similar problem arose several times in the 1970's and 1980's, and each time the politicians kept the fund solvent for several more years by raising taxes or cutting expenses.

> A contest with financial repercussions for millions.

In 1993, as part of President Clinton's deficit-reduction legislation, Congress abolished the income ceiling above which workers owed no Medicare payroll tax and increased the amount of Social Security benefits that are subject to income taxes. This money was earmarked for the Medicare trust fund. All Republicans voted against that bill. Now, Republicans in the House have voted to repeal the additional tax on Social Security payments, and Republican Senators have vowed to follow suit.

SEPARATE MEDICARE FROM THE BUDGET. Last week, Mr. Gingrich, a Georgia Republican, said: "We have decided that we're taking Medicare into a separate box. Every penny saved in Medicare should go to Medicare. It should not be entangled in the budget debate."

He did not explain what he meant, but here is a guess: The Republicans will adopt new budget rules setting Medicare "off budget," just as Social Security is, and asserting that no cuts in Medicare could be used for anything but to shore up the trust fund. As a practical matter, this has little meaning. When the deficit is calculated, off-budget items are counted the same as others. Thus,

the Latest Battlefield

the huge surplus in the Social Security trust fund is used now to make the deficit appear lower than it would otherwise be and can be used by Republicans to show a balanced budget.

The Republicans will still have to propose large cuts in projected spending for Medicare if they hope to balance the budget. But as a political matter, the Republicans could gain an advantage, since every dollar cut from Medicare that goes toward balancing the budget will also count toward making the trust fund solvent, a goal the Republicans hope voters will see as worthy.

If, as seems likely, the Administration refuses to go along, the Republicans can accuse the President of endangering one of the Government's most popular programs.

WSJ 5/1/95 pg. A16

A Coalition Pushes 'Hong Kong on the Potomac,' Or 'How a Flat Tax Can Save the Nation's Capital'

By JOHN J. FIALKA
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – They call it "Hong Kong on the Potomac." The idea is to reinvigorate the sagging economy of the nation's capital by turning it into a "radical enterprise zone," exempting its 580,000 citizens from most federal taxes and, thus, making business flourish.

It has gathered a good deal of political momentum. Jack Kemp, the Republican enterprise guru, predicts the experiment—which would use a Hong Kong-style flat tax—would prove to be a "down payment for prosperity in America," and he has wired together a coalition that runs the gamut from the city's mayor, Marion Barry, to Newt Gingrich, the speaker of the House.

Jack Kemp

But Washington is a most peculiar city and, over the years, it has had a way of thwarting experiments. President Johnson battled poverty here and lost. President Nixon vowed to make the district a model in his war on crime, only to see crime statistics go the wrong way, spurring the flight of white and middle-class black families into the suburbs, which belong to Maryland and Virginia.

Moreover, like most ambitious experiments, "Hong Kong" comes with a hefty price tag. The federal government would forgo some $1.5 billion in tax revenue it normally collects in Washington. In return, because the district would begin to finance itself through its increased taxes, the federal government would no longer pay its annual fee of $660 million to help support the city. But that still leaves an $840 million gap, probably an unbridgeable gulf at a time when the federal budget is shrinking and when many members of Congress see the district as a symbol of fiscal waste and festering urban problems they'd rather not deal with.

"After we pay for an $800 million enterprise zone for the district, we'll put a down payment on the Brooklyn Bridge," said Rep. Jack Kingston (R., Ga.), a member of the House Appropriations subcommittee that oversees the federal city.

'It's Doable'

Despite its slim chances of being enacted in its present form, the plan's advocates are still bullish. "There are a lot of hurdles ahead," notes Mr. Kemp, "but it's doable, and I like the idea of taking a liability and turning it into an asset."

There are a lot of liabilities ahead. This month, President Clinton will appoint a five-member outside control board to oversee the district's finances. It will have the power to restrain Mayor Barry's budgets, impose staff cuts and review labor agreements. Between the board and the mayor, the focus will be to erase the city's estimated $722 million budget deficit over four years.

None of this is going to be easy, because at the moment the district is a kind of fiscal hall of mirrors. According to Congress's General Accounting Office, a chronic lack of proper record keeping has made it difficult to know exactly how much the city owes to outside vendors and contractors. A team of GAO accountants is probing a small mountain of unpaid bills, including Medicaid bills, some of which have languished for years.

Labyrinthine Payroll System

Another mystery, according to the GAO, is how many people the district employs. A labyrinthine payroll system, which pays different people out of different pots of money, has proved almost impenetrable to outside investigators.

Finally, there is no agreement with Congress on how to pay the bills for this fiscal year. Under congressional limits, the district can't spend more than $3.25 billion a year, but in fact several departments, including Corrections and Police departments, are already approaching their annual limits on overtime pay. One complicating factor here, according to investigators, is that it appears that district officials have been encouraging their accountants to keep expenses off the books to appease Congress.

Once the financial bleeding is located and contained, the plan's backers say, the creation of an enterprise zone would be the next step, a way to increase income, property values and the city's slumping bond rating to the point where further deficits wouldn't be created. As Mr. Kemp envisions it, Washington will showcase supply-side nostrums he has been pushing for years.

Flat Tax of 16%

His plan calls for the district to replace its progressive personal income tax with a flat 16% tax rate, exempting those making under $20,000. Corporations would be taxed at a flat 16%. Then property taxes and assessments would be frozen for five years, providing incentives to fix existing homes and buildings.

The theory is that new business and new residents seeking the lower tax status will come into the district and more money will be spent. "I have followed the Hong Kong model for some time," explains Mr. Kemp, asserting that a flat tax is the key to the Asian city's roaring economy.

(According to Kathy Dempsey, spokeswoman for the Hong Kong Economic and Trade Office here, 60% of Hong Kong wage earners don't pay income tax. On the average, those in the higher income brackets pay about 7% on a sliding scale. The city gains most of its tax revenue from levying a flat 15% tax on business profits and from auctioning scarce land in the

(cont)

additional note ↓ pg. A16

tightly packed city of 6.1 million residents.)

Another part of Mr. Kemp's plan is borrowed from the Czech Republic. "There will be a very substantial increase in property value in the district, and we want people who are poor and don't own property to share in that," explains one of Mr. Kemp's main advisers, Russell G. Redenbaugh, a member of the U.S. Civil Rights Commission.

Mr. Redenbaugh would give poorer residents shares in a fund, formed from surplus district property, abandoned buildings and public housing projects, allowing them a way to benefit from the expected increase in property values. Derived from the way the Czech government distributed former state property, it is a way, he says, to "give an asset to people who might not otherwise have a stake in the future prosperity."

Marion Barry

While Mr. Kemp has taken the lead in selling "Hong Kong on the Potomac," the basic notion is home-grown. According to Mr. Redenbaugh, it began several years ago during a Civil Rights Commission hearing when Mayor Barry wondered what the impact would be of reducing or eliminating the district's federal tax burden.

"Jack saw the transcript of that, and then he and I began talking about it," recalls Mr. Redenbaugh, who is chief investment officer of Cooke & Beiler Inc., a Philadelphia-based investment management firm.

Earlier this year, as concern grew over the district's financial problems, Mr. Kemp introduced Mr. Barry to Mr. Gingrich, and interest in the idea blossomed. An aide to the speaker said Mr. Gingrich may try to involve the entire Congress in fashioning a plan to revive the nation's capital as part of a national debt owed to the city's founder: George Washington. "This is all going to happen really rapidly," the aide said.

It can't happen soon enough for Kevin P. Chavous, a member of the district's City Council whose ward is among the city's poorest, located along the border with Maryland's Prince Georges County, where much of the ward's business has fled. "It's an extremely intriguing idea and I think it's something that citizens in Washington are entitled to. We're the only city in America that doesn't have a state government as an anchor. When we lose our middle class, it doesn't continue to help us through the state. It goes somewhere else."

Jesse Jackson Remains Aloof

Eleanor Holmes Norton, the district's voteless delegate to the House, has been deeply involved in the coalition and has authored a bill to end federal taxes here. Jack Kemp "has been my best and most valuable ally," she says. But the Rev. Jesse Jackson, the district's elected "shadow," or nonvoting, senator, remains aloof. He feels that Messrs. Kemp and Gingrich need more consultations with him before they do anything. "This just exposes how fundamentally unworkable it is living under congressional occupation," he says.

The body of legal changes and tax regulations that make up "Hong Kong on the Potomac" will probably undergo a great deal of massaging in Congress. The most eager hands will be the powers that have tended to run things here over the years: congressmen from suburban Maryland and Virginia.

As the new head of the House subcommittee that oversees the district's affairs, Republican Rep. Thomas M. Davis III of Virginia's Fairfax County worries about radical change in the tax system. "If you make D.C. tax-free, all you will do is move the poor to the suburbs and suburbanites go into the city. I don't know if it does anything for the poor of the city except to move them around."

Still, he admits, "You've got to do something different in the district," because in its present crippled economic state it acts as a drag on the whole region's economy. Mr. Davis likes the idea of a semi-Hong Kong on the Potomac, a place where the taxes are gradually flattened but not enough to get his constituents to think about packing. "I think there are variations of the thing that we can look at."

Clinton Gets Bank Backing On Fair-Lending Revision

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON — Three major banks and a large savings institution said they backed a Clinton administration revision of a fair-lending law, highlighting a split between big and small financial institutions over requirements to lend to poor neighborhoods.

Chemical Banking Corp., **BankAmerica** Corp., **NationsBank** Corp. and the Home Savings of America unit of **H.F. Ahmanson** & Co. joined with community activist groups to back the revisions, announced two weeks ago.

Under the rules, big banks will have to report small-business loans according to geographic regions, allowing regulators to scrutinize whether they lend enough in low-income areas. But they won't be required to report the race and gender of their small-business loan customers.

Some other banks are supporting Republican-backed legislation that would broadly exempt small banks from fair-lending law provisions.

WSJ - April 24 '95
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Whither Stocks if Fed Lifts Rates to Defend the Dollar?

ABREAST OF THE MARKET

By DAVE KANSAS
Staff Reporter of THE WALL STREET JOURNAL

As stock prices dance to new highs, here's a grim thought: What would happen to stocks if the Federal Reserve launched a full-blown effort to rescue the dollar by raising interest rates?

Certainly few analysts expect such an effort. The Fed remains focused on domestic concerns, and the dollar's weakness isn't on its radar screen. But pressure beyond the Fed's walls is mounting.

Last week, high-ranking European and Japanese officials complained again about the dollar's worsening health. Even German Chancellor Helmut Kohl weighed in with some heavy criticism of U.S. monetary policy. Most of these international officials want the U.S. to raise rates to protect the dollar, and they will make themselves heard at tomorrow's Group of Seven meeting of economic leaders in Washington. G-7 nations are the U.S., Japan, Britain, Germany, France, Italy and Canada.

"If the Fed did move to defend the dollar by raising rates, it would be a very unpleasant surprise for the stock market," says Walter C. Revis, market strategist for Principal Financial Securities Corp. in Chicago. "Right now, the economic data seems to indicate there's no need for tightening, but it's really more of a toss-up than the market thinks." He notes that Fed Chairman Alan Greenspan "hasn't really indicated how serious he thinks the situation with the dollar is."

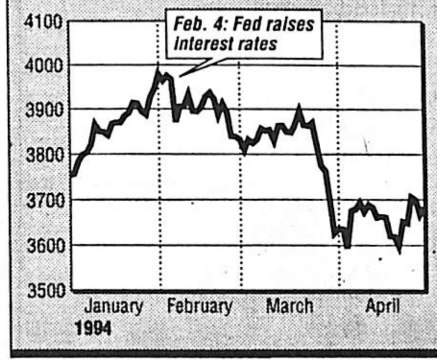
Indeed, the complacency in the stock market surrounding the current interest-rate outlook echoes the same calm that preceded the Fed's interest-rate increase back in February 1994. That Fed move sent stock prices sprawling, with the Dow Jones Industrial Average falling nearly 10% in three months before recovering.

The current political climate, however, complicates any Fed movement. President Clinton's re-election may hinge on an expanding economy into 1996, and an increase in short-term rates would significantly damp the economy's already-slowing expansion.

Moreover, Mr. Greenspan's term as chairman of the Fed expires at the end of this year, and he is reportedly interested in serving another term. Though the Fed is theoretically apolitical, most Fed watchers believe Mr. Greenspan wouldn't want to alienate President Clinton with a sudden rate increase to save the dollar—if it meant risking a recession.

"For the Fed to change the tone in the currency markets, they would need to tighten monetary policy to a degree that it would frighten speculators into thinking we're serious enough about defending the dollar that we would risk a possible recession," says James Griffin, chief economist at Aeltus Investment Management in Hartford, Conn. "Facing that kind of choice, I think the chances are less than 50-50 that the Fed would raise rates with the economy slowing, unless we see a more serious crisis develop."

Remember the Last Time The Fed Surprised Us?
Daily value of the Dow Jones Industrial Average from January to April 1994



And if the dollar keeps dropping, especially against the yen, an interesting crisis could emerge. According to some economists, if the dollar falls to 70 yen, about another 14%, the Japanese gross domestic product then will equal the U.S. GDP in dollar terms.

"That's just an indication how insane the currency markets have become," says David Hale, an economist at Kemper Financial Services in Chicago. "And I think once we reach that level, it could represent a turning point, where the U.S. reconsiders its policy toward the dollar."

Mr. Hale recalls the reaction when the Tokyo stock market capitalization exceeded the New York Stock Exchange capitalization in 1990. "That prompted a lot of intense reaction here, and I think if their economy suddenly became larger in dollar terms that would also prompt a lot of reaction," he says.

While most money managers say it is unlikely the Fed will move any time soon to raise rates in defense of the dollar, some think it likely that such a move could come later this year. The Fed's next policy-making committee meeting is May 23.

"It's almost impossible that they'll do it in the second quarter, but I could see them edging in that direction in the third or fourth quarter," says Kenneth Woods, a money manager at Asset Preservation in Atlanta. "That kind of move would help the dollar, but I don't think bonds or stocks would find it very easy going."

If the Fed sits back, and the dollar continues to fall, Mr. Woods expects that large companies with significant overseas exposure will continue to benefit. Those companies, such as **Coca-Cola**, **International Business Machines**, **Procter & Gamble** and **Caterpillar**, all components of the industrial average, have performed strongly in the past several months, helping push the average to record levels.

"These big stocks are doing extremely well, and a big part of that is their foreign-currency exposure," says Mr. Woods. "But those stocks are getting a little rich, and if you think about what could happen with interest rates, it makes you a little wheezy."

A few strategists argue that a rate rise shouldn't even be considered as part of a dollar defense. They note that the dollar

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U.S. Trade Gap Is Seen Growing By 27% in 1995

Think Tank Says Deficit Will Reach $200 Billion, Staying There for Years

ECONOMY

By HELENE COOPER
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – Just days after U.S. trade officials were encouraged by February's narrowing of the trade deficit, a leading economic think tank predicts the widest measure of the trade gap will balloon 27% to $200 billion this year.

Even more ominous, William Cline, the economist with the Institute for International Economics who prepared the forecast, predicts that the current account deficit will remain at the $200 billion level for several years. His findings, to be released today, indicate that the dollar's recent decline is rooted in the growing trade deficit and isn't merely a whim of financial markets.

While many economists have predicted an increase in the trade deficit in the next year, few believe it will expand to $200 billion, and many expect it to begin shrinking next year.

Tracking the Economy is on page A4.

Mr. Cline concludes that the U.S. is traveling down a dangerous path that could lead to an economic downfall. C. Fred Bergsten, director of the private institute, points to Mexico as an example of the economic peril of a big trade deficit. Mexico's peso crisis largely has been blamed on that country's massive trade deficit, which approached 8% of the country's gross domestic product – the total value of goods and services produced there–in December.

With such a yawning gap, investors feared Mexico wouldn't be able to pay for its imports or pay back its debts without devaluing its currency and begging for help. As the peso drops, the value of foreigners' Mexican holdings declines, too. Investors bolted, fearing the worst.

In the U.S., the current account deficit is about 2.3% of GDP. Mr. Cline's report forecasts the current account deficit in 1995 will equal about 2.6% of U.S. GDP – nowhere near Mexico's league but still well above the 1% to 1.5% economists say they'd like to see.

"When you let your trade deficit go up like this, you're really setting your economy up for a collapse," Mr. Bergsten said.

The current account includes trade in goods and services, investment income and government grants. The U.S. current deficit soared in 1994 to $155.7 billion from $103.9 billion in 1993.

Because Mr. Bergsten is a Democrat and talks with Clinton administration officials, his views sometimes move currency markets even if he isn't in sync with administration policy. Mr. Bergsten said that another 10% drop in the dollar against a wide array of currencies is needed before the trade deficit will drop significantly, but that the dollar shouldn't decline any more against the Japanese yen. Were it not for the recent fall of the dollar which made American exports cheaper abroad, the U.S. current account was headed toward an even bigger deficit of $250 billion by 1997, the report said.

What this means, Mr. Bergsten said, is that it would be a mistake for the U.S. to intervene forcefully to boost the dollar. Instead, he advised, federal policymakers should cut the federal budget deficit as a way to shrink the trade deficit.

There is one bright spot in the report: The dollar's decline, Mr. Cline says, has been much smaller than generally recognized. Although the dollar has fallen by 17.5% against the Japanese yen and 13% against the German mark since 1994, it is only down about 7% against the currencies of other industrialized nations, and is down even less on a trade-weighted basis that includes currencies of developing countries.

Mr. Cline's analysis finds that a further decline of the dollar against the Japanese yen would be unwarranted, but that the dollar needs to fall against a broader set of currencies, including those of the newly industrialized countries of Asia.

Federal Home Loan Banks Squabble Over Payments to Thrift-Bailout Fund

By JOHN CONNOR
Special to THE WALL STREET JOURNAL

WASHINGTON – The Federal Home Loan Bank System, soon to be the object of congressional "modernization" efforts, is engaged in an intramural squabble over the allocation of a $300 million-a-year bill it owes to service thrift-bailout bonds.

The bank system, comprising 12 regional home loan banks, is a government-sponsored enterprise created in 1932 to provide low-cost loans, called advances, to mortgage lenders. Once confined to thrifts, its 5,400 members now include banks, credit unions and insurance companies.

The Federal Home Loan Bank of San Francisco last year increased its activity in transactions known as resale, or reverse-repurchase agreements more than fourfold, with outstanding agreements climbing to $10.7 billion at the end of 1994, from $2.5 billion at the end of 1993, according to an internal Federal Housing Finance Board memo. The board regulates the system.

Resales Skyrocketing

While its resale-agreement activity was skyrocketing to account for 77% of the system's outstanding volume of such transactions at the end of 1994, the San Francisco bank's advances to member institutions fell in 1994 to below the system's average, the Finance Board memo said.

This wouldn't matter except that resale agreements don't count – and advances do – in calculating part of the allocation among the district banks to cover the system's obligation to pay $300 million each year to service $30 billion of bonds sold by the Resolution Funding Corp., an off-budget entity created by Congress in 1989 to fund part of the thrift-industry rescue operation.

The decline in advance growth by the San Francisco bank will cause it to pay less this year toward the Refcorp "shortfall," and other banks to pay more, the Finance Board memo said. It said San Francisco's share of the Refcorp shortfall payment will be reduced by 5% in 1995.

The Refcorp payment formula requires all district banks first to contribute 20% of their net income to the Refcorp payment. If the total is less than $300 million, as it always has been, the shortfall is allocated among the banks in proportion to each bank's share of the average advances to members insured by the Savings Association Insurance Fund.

Urging Regulators to Reclassify

According to an Indianapolis FHL Bank analysis, assuming a shortfall of $80 million and system-level advances of $100 million, a shift of $1 billion from advances to resale agreements results in a Refcorp [illegible]

The Indianapolis bank, backed by four other district banks, wants regulators to reclassify resale agreements as advances for the purpose of calculating the Refcorp shortfall payment, the Finance Board memo said. Other banks are known to be in sympathy with this position. The issue is under study, a Finance Board spokesman said.

William Hamm, chief operating officer of the San Francisco bank, said the resale surge is "market-driven" and not a dodge to cut the bank's share of the Refcorp bill. Resale transactions aren't advances in disguise and aren't made at the expense of advances, he insisted. In a resale or reverse-repurchase agreement, a party – in this case an FHL bank – lends funds to a customer in exchange for securities, agreeing to resell the securities to the customer at a future date. A repurchase agreement, or repo, is the same transaction from the customer's perspective.

Jonathan West, general counsel of the Indianapolis bank, said the heavy use of resale agreements and declining advances by a given bank effectively shifts Refcorp costs to other banks, and that resale agreements are the "functional equivalent" of advances under existing legal opinions. But Mr. Hamm of the San Francisco bank has said interest rates on repos are significantly lower than the rates on advances, because of supply and demand conditions in the credit market.

The dust-up comes as Congress prepares to modernize the Home Loan Bank System. The focal point is a bill recently introduced by Rep. Richard Baker (R., La.), chairman of the House subcommittee with jurisdiction over the system. Rep. Baker plans to hold hearings and to mark up a bill in May. His bill would allocate Refcorp payments among the regional banks in proportion to the average minimum level of capital they would be required to maintain under the measure. The proposed minimum-capital standards are comparable to those for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp.

Date: Fri, 7 Apr 1995 16:22:11 -0400 (EDT)
From: David Kettler <kettler@bard.edu>
To: shaikh@levy.bard.edu
Subject: saving you more time

Dear Anwar,

I am transcribing my NYC notes from last week's research foray (which I want to discuss some time) and found the following scanty abstract of Manning Marable's longwinded talk. This, I suppose, is what we missed when he stiffed the Levy:

Manning Marable, "Changing the Liberal Agenda"

White males reject remedies for race/gender based inequalities in principle even though affirmative action in fact excludes poor.

Breakdown of 1994 election figures shows white male backlash to reform. Prefigured by 1968 Nixon victory and 1980 Reagan revolution. Originating in Goldwater candidacy "third wave" builds on these movements, supported by many institutional resources. The political Right enjoys a hegemony of political ideas and analysis.

The challenge to Blacks: Civil rights movement was conditioned by liberal context, but the liberal leadership has failed to rethink policies. The old program which has created this great backlash, notably affirmative action, was not even implemented.

Call for shifting from liberal themes to a comprehensive agenda of social justice capable of mobilizing millions.

While the group was assembling for the panel on which Marable was listed, I went up to the only black man at the speakers' table and said I wanted to shake his hand, having waited for him in vain at Bard. The pleasant man I addressed explained that he was not Marable, but his junior, and that he was there to read Marable's paper, since Marable could not fit it in. Ah, greatness. David

Date: Fri, 7 Apr 1995 16:36:43 -0400 (EDT)
From: David Kettler <kettler@bard.edu>
To: shaikh@levy.bard.edu
Subject: wasting your time

The joke is over, but I am too much of a pedant not to send you the attached second page of Marable notes, which I had misplaced:

Note worsening income disparities: even white women, who are main beneficiaries of affirmative action remain at $.70 for every white man's dollar.

Political importance of legal and political assaults on set-asides and taxbreaks, in conjunction with affirmative action. Dangerous new alliance between anti-affirmative action and anti-tax groups in California. "Racial and gender preference" programs strongly opposed in public opinion polls.

Question is whether it is enough to defend affirmative action as it exists. Search for alternative designs to escape stigma of rewarding inferior ability. For example: scholarships for top 10% graduating every high school. If some schools poorer, best cannot do anything but be among the best in their schools. Also scholarships for first-in-family-to-university and to students from families with incomes under $35000.

Not effective politics to defend old liberal reforms: need to meet those distrustful of reverse discrimination if there is to be social justice coalition.

Board of Governors
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Leon Levy
S Jay Levy
Dimitri B. Papadimitriou
Edward V. Regan
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Board of Advisors
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Edward L. Hutton
Lord Harold Lever
Hyman Minsky
Franco Modigliani
Senator Daniel Patrick Moynihan
Jane Bryant Quinn
Henry Rosovsky
Eugene Rotberg
Paula Stern
James Tobin
William Julius Wilson

DATE: March 14, 1995

TO: Institute Scholars and Staff

FROM: Sanjay Mongia

SUBJECT: Workshop on Full Employment

As you know, the next workshop on full employment is scheduled for Friday, March 17. I hope that all of you will be able to join us for another thought-provoking session.

At my request, David Ladipo and Oren Levin-Waldman agreed to summarize the two previous full employment workshops. They have articulated the themes of the past discussions and identified the salient points that may be worthy of further consideration during our meeting on Friday. I would like to take this opportunity to thank David and Oren for their efforts.

Levy Institute Unemployment Workshops

Session One - Cyclical Unemployment

Common to all of the workshop's participants was an antagonism to the neoclassical perspective on full employment. As described by Hy Minsky, Willem Thorbecke and Charles Whalen, this perspective is characterized by a fanatical and dangerous belief in a world of "general equilibrium".

In neoclassical theory, the labor market is treated as just another market: if the quantity of labor supplied is greater than the quantity of labor demanded, then unemployed workers will "price" themselves back into the market by lowering their wage demands until "equilibrium" is restored. Once at this equilibrium point, increases in employment can only come at the expense of inflation. This trade-off takes on an elegant graphical form in the shape of the famous Phillips Curve.

The implications for public policy are self-evident. If the economy constitutes a self-regulating, equilibrating, price system, then any "exogenous" attempt to increase

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employment (e.g. government fiscal or monetary measures to increase output) will only come at the expense of inflation.

Nevertheless the empirical evidence in favor of the inflation-unemployment trade-off is far from overwhelming. Anwar Shaikh pointed out that the post 1975 OECD experience points to the "normal" Phillips Curve pattern of higher unemployment signalling less inflationary pressure. But the experience in the ten years preceding 1975 points to the very opposite: *higher unemployment is generally associated with less inflationary pressure!* While from the micro perspective, George McCarthy reported that in his studies of human migration in the United States, wage levels are remarkably insensitive to labor supply movements.

Both Shaikh and McCarthy's observations reinforced Hy Minsky's judgement on neoclassical theory: a theory based on the notion of equilibrium which ignores Keynes' famous proposition that "it is in the *disequilibrium* that we live out our lives." A proposition that used to command some respect. Charles Whalen noted that in the wake of the Great Depression, economists developed a synthesis of classical and Keynesian insights: "the key was in recognizing that *time* played a role. Countercyclical policy was justified because although in theory the system might eventually get to full employment, it wasn't there yet and good government action could help to speed along the natural market tendencies.

But irrespective of this Keynesian stance on unemployment, many of the participants at the workshop adopted the view espoused by Oren Levin-Waldman, namely that even if there is an inflation-unemployment trade-off, then so what? Why not live with a little bit more inflation if it means fewer people unemployed.

This is the response of the NAIRU (the non-accelerating inflation rate of unemployment) cult. The members of the NAIRU school of thought share the neoclassical view that unemployment can only be reduced when inflation "fools" workers into supplying more labor at the same real wage. Thus, while Keynesians argue that there need not necessarily be any trade off between inflation and unemployment, NAIRU adherents argue that we cannot--whatever the cost in terms of unemployment--allow there to be a trade off lest we get eaten by the insatiable dragon of ever-accelerating inflation. Wynne Godley responded poignantly to this debate by proclaiming: "I completely reject the proposition that any addition to employment above some econometrically estimated number will inevitably cause inflation to rise to infinity, at a time when significant numbers of reasonably qualified people are willing to work for a decent wage but cannot do so. The proposition is not anyone's 'finding'; it is a property of certain economists' models and is there because it has been put there. And it is obvious nonsense".

There was consensus over the following propositions:

- "Full employment should be the gainful employment of all who desire it" (Anwar Shaikh)

- We "do NOT accept that the so called NAIRU or any definitions of the 'natural' rate of unemployment can or should be identified with full employment as defined above" (Wynne Godley)

- The current rate of unemployment in the United States is deemed to be substantially (and unjustifiably) in excess of full employment on the above definition (Jay Levy)

- We should be wary of the deification of "the" unemployment figure. The goal is not that of determining whether the figure is 6% or 5% or 4%. "The goal is to *move* it downwards!" (Jay and David Levy).

But does the advocacy of these propositions represent a Quixotic undertaking? Wynne Godley certainly gave the impression of someone well versed in the art of tilting at windmills, forcefully reminding the workshop's participants that the "political establishment" is extremely hostile to such views and is wedded to economic theories which deny the reality of involuntary unemployment at the same time as they ensure its very perpetuation. Similar sentiments were expressed by Willem Thorbecke in his observations on the power of bond market participants, who have an incentive to argue for a high 'natural' rate of unemployment in order to avoid any risk of monetary policy being too expansionary and re-igniting inflation. Thorbecke noted that Alan Greenspan's seven interest rate rises over the last year strongly give the impression that the Fed is siding with the banks and the bond market, avoiding any chance of major reductions in unemployment.

Charles Whalen was more optimistic, believing that while the financial interests might be heartened by the Fed's policies, chief executives in the industrial and non-financial services sector are not at all convinced by Greenspan's deflationary policies and it is to these individuals that we should look for support in advocating a full employment agenda. I believe that the muted response by the administration in reference to the Federal Reserve's policies is in sharp contrast to the vocal and sharp criticism of the Fed expressed by the National Association of Manufacturers and the Chamber of Commerce. Focusing the debate solely on inflation and the role of the central bank is to miss the distinction between the "financial" constituency and the "main street" business constituency.

Session Two - Technological Unemployment

As defined by Hy Minsky, the effect of technological change is to decrease the number of workers needed to produce a given output within a particular industry: in the currently fashionable terminology, process innovations lead to displaced workers. David Levy would prefer to focus the discussion in terms of policies that would generate opportunities. Both David and Hy acknowledge that high demand for labor would implicitly lead to price inflation.

In demand and supply terms, there are only two ways to prevent process innovations leading to unemployment: either the demand for labor goes up in other industries (i.e., product innovations lead to job creation), or the supply of labor increases (i.e., workers reduce their price).

With regard to labor demand, Wynne Godley noted that the dominant economic and political ideology has emasculated government of all its demand managing and growth stimulating properties. The central function of NAIRU and all the other icons of neoclassical "equilibrium" theory is that of convincing people that the government should not interfere with the demand side of the economy. The result is that "it limits the task of things which you can do about employment to what I call being beastly to the unemployed--making their experience particularly disagreeable by reducing the minimum wage, cutting benefits etc.". "The political meaning of this is that we can't approach economic policy at all in the way that was so successful before 1974 and is still the way in which I believe...and which is the right way to get unemployment down...That is, we can, and have to, run economic policy in a way that ensures that we have moderate, well-balanced growth."

Anwar Shaikh reinforced Godley's remarks by noting that between 1965 and 1991, the rise in OECD unemployment was clearly correlated with the fall in growth rates. Hence "the relevant policy debate is about *how* growth rates are to be raised, which in turn is closely related to the debate about *why* growth disappeared in the first place." For Shaikh, a policy position in favor of (more or less) full employment must be linked to a sound theoretical and practical foundation and yet most existing foundations, particularly in economics, have proved inadequate in this respect. Nevertheless "we are privileged to have at the Levy Institute, distinguished scholars such as Hyman Minsky and Wynne Godley, whose frameworks have proven their worth in practice and we need to make more systematic use of these foundations!"

Wynne Godley further noted that even when there is growth, the effect on the labor market is dependent upon social and political institutions, and in particular on the redistributive mechanisms of the society. He noted that of all the OECD countries, Mexico has the lowest unemployment rate:

> "If people cannot get proper jobs they scramble along, in Mexico and the Third World and just do the best they can not to starve. It is only in a completely meaningless sense that there is no, or very little, unemployment in Mexico. But just for the reason that it makes no sense to say that there is next to no unemployment in Mexico, it is becoming of desperate importance to keep track of the plight of the so-called 'working poor,' a vast category of American workers whose real pay has now been falling absolutely for about ten years. If the trend continues, and particularly if the economy (and therefore the average real income of all other Americans) continues to rise, the result could be as distressing and as politically dangerous as if unemployment were higher than it actually is."

WSJ 3/24/95 p.A2

Jobs Data Undergo Big Upward Revision

Almost 1.4 Million More Were Employed in 1994 Than Had Been Thought

By FREDERICK ROSE
Staff Reporter of THE WALL STREET JOURNAL

Each March, the Labor Department rewrites employment history, refining its calculations of how many people worked at the end of the year, and where they worked.

This year's result: Unannounced and unnoted beyond a small circle of economists with access to computerized databanks, the department's Bureau of Labor Statistics has determined that there were nearly 1.4 million more people employed in the 50 states and District of Columbia than previously thought, a 1.2% increase.

This is not only one of the largest upward revisions of recent years, but on closer inspection it shows important trends in regions across the country, says David Hensley, an economist at Salomon Brothers Inc., in a study to be published today.

Widespread Growth

As Mr. Hensley sees it, now-revised numbers in individual states and cities both reinforce a view of widespread growth and, at the same time, warn that some of the fastest-growing regions may be peaking. "What is clear, now that the dust has settled, is who has momentum and who doesn't," says Mr. Hensley.

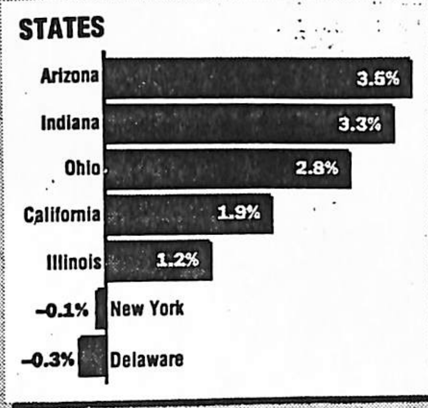
With a stroke of the pen, the Labor Department's recalculation of California's totals, for example, added more than 230,000 jobs, or 1.9%. Some 137,000 jobs, or 2.8%, have been added to Ohio's count. And 88,000, or 3%, were added in Indiana.

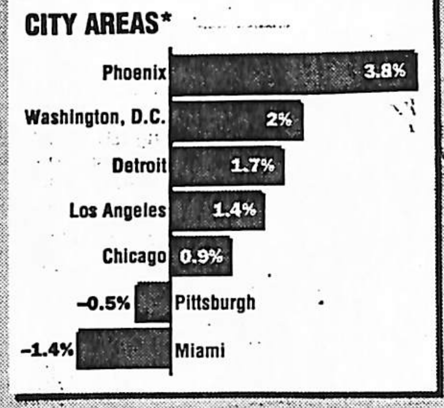
Only two states were revised downward. New York's count was stripped of 5,400 positions, or a tiny 0.1%. Delaware lost 1,100 jobs, or 0.3%.

In the California case, the revisions, which had been expected, changed a picture of continuing employment contraction in the nation's most populous state last year to one of modest growth. Before the boost, California employment last year was thought to have declined about 0.7% instead of rising 1.2%, as it's now believed to have done.

Winners and Losers in Employment Revisions

Percentage change between the Labor Department's original job total and employment revision





Sources: Labor Department, Salomon Brothers Inc. *Metropolitan statistical areas

Subtle Changes

More striking are subtle changes within California, Mr. Hensley says. As now updated, the southern part of the state shows employment growth while the northern part — which was believed to be in far better shape—shows a flatter line.

Employment in the Los Angeles-Long Beach metropolitan area, which received the largest single revision of any urban area, is now seen as having grown 1% last year after losing 2.4% in 1993. Orange County, after upward adjustment, gained 1.5% in employment in 1994 compared with a 0.8% loss a year earlier.

By contrast, Northern California, where adjustments were smaller, saw losses or little growth last year. Employment fell 1.1% last year in San Jose County, the heart of Silicon Valley, compared with a 0.9% gain a year earlier. In the San Francisco area, the job count slumped 0.8% last year after a 0.1% loss in 1993. And in the agricultural region of Fresno, employment gained only 0.2% last year, compared with a 2.2% gain a year earlier. "This really defies the conventional wisdom about California," Mr. Hensley says.

Benchmark Numbers

The basis of these revisions is an annual recount taken from state unemployment-insurance tax records. The recount is used to create so-called benchmark numbers for nonfarm employment. The changes made this month technically create the March 1994 benchmark. These new benchmark numbers, in turn, are used to recalculate last year's employment data and will be used for future estimates until next year's benchmarking exercise.

A similar exercise is used to benchmark national employment numbers, which are separately calculated rather than being summed from individual state data. Although the 1994 national adjustment hasn't been officially announced, it's expected to be an increase of about 600,000, says Mark Zandi, chief economist at Regional Financial Associates, an economic consulting firm in West Chester, Pa.

Even though, in the regional and metropolitan series, employment levels were revised downward in two states, the newly adjusted numbers show that employment grew last year in all 50 states and the District of Columbia. It was the first time since 1988 that every state in the U.S. added jobs.

"That's really extraordinary," says Mr. Hensley. But the economist cautions against a view that the nation as a whole is growing equally. Indeed, he says, some areas appear to be peaking.

The leading candidate for the "peaking" category is the Rocky Mountain region, says Mr. Hensley, where an outstanding 5.4% employment gain last year actually represents a slide from a 5.9% increase in 1993. Mr. Hensley considers this an important loss of momentum that may reflect, in part, a slowing outmigration of population and economic activity from California. And, he warns, the region's economy is strongly linked to real estate and construction activity, which in turn is vulnerable to rising interest rates.

'Torrid' Phoenix Eases

Focusing on Phoenix, for instance, Mr. Hensley says the metropolitan region's "torrid" employment growth, though boosted in the revisions to 6.6% last year, represents a slip from 6.7% a year earlier.

In booming Las Vegas, where 29,800 jobs were added in the revisions, the year-to-year employment growth peaked at 13.5% in September, slid to 10.8% in December, and was a still-extraordinary 9.8% in January. That, says Mr. Hensley, suggests the boom is slowing.

In some cases, while employment growth suggests gains in momentum, those gains are relatively small and other factors raise warning flags, says Mr. Hensley, repeating past doubts about the industrial Midwest states, for instance. Although Ohio, Indiana and Illinois all got strong employment revisions and employment in the Midwest as a whole gained 2.5% last year compared with 2.1% the year before, Mr. Hensley says the economic activity there will probably slow later this year.

"The Midwest has been the prime beneficiary of export growth and demand for capital goods," Mr. Hensley says. "That's precisely why the region is at risk as the accumulative effects of [Federal Reserve] tightening of interest rates take hold."

WSJ p. A1 4-11-95

THE BOOM in the temporary-help business might slow, but not by much.

Employment growth for temporary workers will fall to the mid-teens later this year from a year-over-year average of 21% in 1994, predicts Judith Scott of Robert W. Baird & Co., Milwaukee. Touting temp help as the "growth industry of the 1990s," the securities analyst notes that even that slower pace would far outstrip almost every other industry.

The growth is bad news for workers who want permanent jobs with benefits. A study by two economists at the Federal Reserve Bank of Chicago finds blue-collar temps earn 34% less than full-timers, while white-collar temps make 2% more than their full-time counterparts. Economists also find that the increased use of temps in manufacturing means that the decline in manufacturing jobs in 1992 and 1993 might have been overstated by as much as 50%.

IS WELFARE REFORM scaring people back into the work force?

Wisconsin says its welfare caseload fell to 74,000 last year from 98,000 in 1987, and only part of that is due to a strong economy. The state has a pilot project in two counties that limits cash benefits to 24 months. For next year, Governor Tommy Thompson proposes to eliminate the state's share of general assistance, paid mostly to single males.

Koss Corp., the speaker maker in Milwaukee that had trouble getting full-time production workers last year, says 28 of 30 temporary workers recently accepted full-time jobs that start just above the minimum wage but include benefits. "Uncle Sam has been a pretty tough competitor for a long time," says Michael Koss, president. But Milwaukee County figures 40% of the 5,000-plus people who stand to lose general assistance are disabled in some way.

"There just aren't going to be that many beginning jobs that pay a living wage," says Robert Magill, a professor at the University of Wisconsin's school of social welfare.

WSJ 3/27/95
p. A2

Jobless Claims Up 3,000 In Latest Week Survey

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON—Initial claims for state unemployment insurance rose 3,000 in the week ended March 18 to a seasonally adjusted 346,000, the Labor Department said.

Initial claims have risen for three consecutive weeks—the first time claims have risen three weeks in a row since April 1994, the Labor Department said.

In the week ended March 11, a total of 2,548,000 people were receiving state unemployment benefits, up 48,000 from a revised 2,500,000 million the previous week. The number of people receiving unemployment benefits as a percentage of those covered by unemployment insurance was unchanged at 2.3% in the week ended March 11.

The World

Do Fickle Markets Now Make Policy?

By DAVID E. SANGER

WASHINGTON

THE domino theory is alive and worried about in Washington.

A generation ago, the fear was over Vietnam and whether its fall to Commun[illegible]sm would inevitably take Thailand or Malaysia or Indonesia with it. The Vietnam of the economic age is Mexico, and the insurgents are brandishing not AK-47's and ideology but "hot money." That is what Wall Street calls the billions of dollars that investor[illegible] move in and out of countries in minutes. [illegible]nd suddenly the task of trying to direct or [illegible] least contain that flow before it topples th[illegible] next domino is remaking the conduct of [illegible]erican foreign policy.

To a de[illegible] rarely seen before, bond traders and [illegible] currency markets are driving policy, ra[illegible] than reacting to it. For the evidence, jus[illegible] at the faxes that that have been ex[illegible]ged in recent weeks between officials [illegible] Treasury Department and the leaders [illegible] Mexico, Argentina and Brazil. In Mexic[illegible] Mexico, [illegible] Treasury officials led President Er[illegible]se, Zedillo to the unhappy conclusion tha[illegible] had to spark a deep recession — sendi[illegible] [illegible]rest rates on credit cards to upwards [illegible] percent, bringing imports to a near h[illegible] [illegible]f he had any hope

> Mexico is the Vietnam of the economic domino theory.

of luring scared investors back into the country. Drastic measures have also been prescribed in Argentina, which just been lowed hard, accepted a $7 billion bailout package from the International Monetary Fund, and prayed that investors would stop fleeing the country in herds.

In short, these days countries are often finding that they have to destroy prosperity in order to save it. In Mexico, that means laying off hundreds of thousand[illegible]

the name of paying off the short-term bonds that the country sold with abandon last year. "It is a whole new set of priorities," said a Clinton Administration official. "Forget everything you learned about how to help developing nations. Now it's Fidelity first."

Can We Talk?

Is this really the message America wants to send around the world? "It's a good question, and one we discuss a lot," said Treasury Secretary Robert E. Rubin, the onetime co-chairman of Goldman Sachs, who has played this game from both sides of the table. "It is tempting to say that markets don't care about the social considerations, about schools or income disparities. But I think the truth is a little different. Don't get me wrong, we're not talking about investors with a conscience. But they want to get their money back, so they are interested in all the financial pieces, but also in what this will do to social and political stability. And in the end, I'm not sure the priorities are so different."

Whether Mr. Rubin is right or not, ever since the Mexico debacle you cannot walk through Wall Street without tripping over Latin American leaders trying to convince investors to bring their billions back, or at least not suck away what little is left. Several made the trip last week; Peru's President, Alberto Fujimori, came just to make the case that his country is not like Mexico.

But the fact that they come at all reveals how much has changed. When the Latin debt crisis struck a decade ago, all the lenders, representing the world's biggest banks, got into a room, negotiated austerity measures and reluctantly granted the countries time to work things out.

In the '90's, bankers don't matter; markets do. "This isn't a situation where you can sit down and reason with someone, because there is no one to talk to," said Joan Spero, the Under Secretary of State for Economic Affairs. "Have you ever tried to get a market into a hotel room?"

But the harsh truth, as the Mexicans are learning, is that almost no amount of austerity will convince most investors to return. What fund manager will risk his job on the bet that Mexico is getting its act together — especially when Indonesia is hot, India looks like a cheap Silicon Valley and Germany has become a safe haven of strong currency? As one fund manager said, "No one is going to get fired for staying out of Mexico."

That is the price the country is paying for decisions made in the last days of President Carlos Salinas de Gortari. He bet that he could keep the peso artificially high by hiding bad but complex news about the economy. He is now in self-imposed exile in the United States, sounding defensive.

His biggest mistake was relying on hot money rather than following the example set by countries like China, Malaysia and Thailand — who have urged foreign investors to invest in factories and other assets that cannot be swept out the country with a few strokes of the keyboard. A senior European finance official, however, blames not only the Mexicans but the industrialized nations that bailed the country out in the 1980's. "It is like being a doctor, and giving the patient a heart transplant, which is what we did a decade ago," he said. "You would expect that the doctor should be checking things out every year or so. But we were all so enthralled by the success of the operation that no one did a check-up."

Keeping Secrets

Even when the doctors dropped by, Mexico set the rules: no X-rays, no blood tests. The Salinas Government carefully kept key statistics out of the public domain — how much its foreign reserves had been depleted to prop up the peso, how dependent it had become on short-term money from abroad. The shell game deceived even the I.M.F.

"The whole surveillance process did not work the way it should have," Karin Lissakers, the chief United States representative to the I.M.F., said last week. "We were too tolerant" of Mexico's reluctance to turn over vital numbers.

Someone did see and understand many of the warning signs — the United States Treasury. It has turned over hundreds of pages of documents to Congress, detailing warning after warning to the Salinas Government. Yet no one dared utter a word in public. In fact, President Clinton lauded Mexico's economic reforms at the Latin summit meeting in November.

The case for silence is simple: Public warnings may trigger the rush for the exits that everyone is trying to prevent. But by keeping Mexico's secrets, the United States likely contributed to the ferocity of the ensuing panic.

Mr. Rubin hopes that Mexico's extraordinary pain is sending a message. "I think there is no question that people who govern other countries, when they see what Mexico is having to do, are going to feel an enormous incentive to maintain sound policies," he said. Otherwise, he will be left to pick up the dominoes.

Stephanie Berger

Investors are driving U.S. foreign policy. Austerity measures backed by Washington make it hard for these Mexicans to find work.

WSJ 3/23/95 p. A2 & A10

Treasury, Congress Disagree How Much GOP's Gains-Tax Cut Benefits the Rich

By LUCINDA HARPER
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – Scorekeepers at the Treasury and those in Congress have quietly changed the way they measure who are the biggest beneficiaries of cuts in the capital-gains tax.

The result: The Treasury's changes make the Republican tax-cut bill look extremely generous to the rich. Changes by the congressional Joint Committee on Taxation make the same tax cuts look less generous to the wealthy.

Each side defends its new approach with arguments that some academic economists support. But outsiders versed in the arcane but politically significant issues say the appearance is one of partisan angling. "This should be based on independent, nonpartisan, professional judgment," says Michael Graetz, a former Bush administration Treasury official who now is a Yale Law School tax professor. "But when you switch the way you do things, it gives people less confidence that is the case."

The Clinton Treasury estimates that the tax cut approved by the Republican-led House Ways and Means Committee would reduce taxes for Americans with incomes above $200,000 by nearly 10%; no other income class would get a bigger break. The Joint Committee on Taxation, now overseen by Republicans, says the very same tax bill would give the over $200,000 class a tax break of less than 3%; the biggest tax cut, proportionately, would go to those with incomes between $30,000 and $75,000.

Who Wins?

Two views of the same House GOP tax-cut bill

INCOME	CHANGE IN TAXES	
	TREASURY	CONGRESS
Under $10,000	–5.2%	–2.3%
$10,000-20,000	–7.0	–3.4
$20,000-30,000	–7.4	–3.9
$30,000-50,000	–8.3	–4.4
$50,000-75,000	–8.2	–4.4
$75,000-100,000	–8.7	–4.0
$100,000-200,000	–8.6	–3.7
$200,000 and over	–9.9	–2.9

NOTE: Treasury and Joint Committee on Taxation use different definitions of income and different ways to evaluate capital-gains tax cuts. Treasury includes corporate taxes, JCT doesn't. Treasury figures for fully phased-in tax cut, JCT figures for 2000.

Sources: Treasury Department, Congressional Joint Committee on Taxation

What's going on? Treasury and congressional technicians have always measured tax changes differently, and capital-gains tax cuts have always been particularly thorny. Indeed, Democrats have successfully used Joint Committee distribution tables to paint proposals to cut the capital-gains tax as a boon to the wealthy. President Bush never managed to overcome this objection. But the last time capital-gains taxes were at issue, the Treasury and the Joint Committee took the

Please Turn to Page A10, Column 4

Treasury, GOP Dispute Amount Gains-Tax Cut Benefits the Rich

Continued From Page A2

opposite positions from the ones they now advocate.

Corporate Tax Cuts

Complicating this year's disagreements are the big-business tax breaks under consideration. The Treasury, as it has in the past, figures these into its analysis. The Joint Committee doesn't.

Calculating who benefits from a corporate tax cut has always been difficult. Is it shareholders or workers or consumers? For years, the congressional tax technicians couldn't decide. Then, in June 1993, they concluded the corporate tax is ultimately paid by the owners of capital, and published that conclusion in a pamphlet.

shifting

But that's not the way they're looking at this year's proposed corporate tax cut. They ignore the corporate tax breaks altogether in analyzing how the tax breaks are distributed. "I don't believe we're smart enough to figure out who pays a corporate tax," says Kenneth Kies, who was appointed to oversee the Joint Committee by the new Republican leadership. The committee is responsible for all revenue and distributional analyses of tax bills.

Some outside tax economists strongly disagree. "Ignoring the corporate tax is clearly a loony thing to do," says Harvey Rosen, who heads the economics department at Princeton University and was the Treasury's top tax economist in the Bush administration.

The thornier issue is measuring just who benefits from cutting capital-gains tax rates. In the past, congressional estimators looked only at assets that investors would have sold anyhow—even if capital-gains tax rates didn't change. The Treasury, at least in the Bush years, strenuously argued that was the wrong approach. It looked at all assets sold — those that would have been sold anyhow and those that were sold because the tax bite was reduced. This approach makes the capital-gains tax break look much less like a sop for the wealthy.

Examples of the Two Approaches

Suppose a person turns a $50,000 profit on the sale of stock. Under the current tax rate of 28%, the investor would pay $14,000 in taxes. If the tax rate were cut in half, as the GOP proposes, the tax bill would fall to $7,000. Under the Treasury's current approach, the investor just saved $7,000 in taxes.

Congressional estimators, reversing a position they have held for more than a decade, go one step further. They factor in the taxes that would be paid because investors are likely to sell more stock if capital-gains tax rates are reduced. The same investor would, say, report $80,000 in profits, not just the $50,000 the taxpayer would have had anyhow. With a new lower tax rate, the tax bill would be $11,200 (14% of $80,000). The investor's total tax cut is then only $2,800 ($14,000 minus $11,200).

!

Mr. Kies says the change was made by his predecessor, John Buckley, who was named by Democrats; other committee staffers confirm that. Mr. Kies says the current method is easier for members of Congress to understand.

Although the Treasury's analysis is done by career government employees, big decisions are made by political appointees. Eric Toder, head of tax analysis for the Treasury, acknowledges that the department has changed its approach. "We believe the method we are using now best represents the distributional effects of cutting the capital-gains tax," Mr. Toder says. He notes this isn't the first time the Treasury has made a change; the Clinton Treasury approach now matches the one used in the Reagan years, he says.

Some economists and tax experts say there are merits to each approach. "These are both reasonable approaches, they are just answering different questions," says Princeton's Mr. Rosen.

But in the current politically charged atmosphere, the motives of both sides are often suspect. Yale's Mr. Graetz says in a coming piece in the Columbia Law Review that the only solution is to abandon the distribution tables altogether because they are "false and potentially misleading."

WSJ p. A2 & A8

WEDNESDAY, MARCH 15, 1995

ECONOMY

Foreign Investment in U.S. Surged in 1994

China Is Replaced as Lead Recipient; Economy Is Cited

By FRED R. BLEAKLEY
Staff Reporter of THE WALL STREET JOURNAL

The U.S. received more investment from foreign firms than any other country last year, supplanting China as the leading investment destination.

The preliminary findings by the United Nations found that total foreign direct investment both in developed and developing countries hit $204 billion last year, up from $193 billion in 1993. Of the total, $41 billion was invested in the U.S., nearly double the $21 billion invested in 1993. Direct investment includes acquisitions and the formation of new buinesses or plants. It doesn't include the purchase of securities such as stocks or bonds.

Analysts said foreign firms flocked back to the U.S. last year due to the improving economy, the passage of the North American Free Trade Agreement with Canada and Mexico, the loosening of regulations and "the general feeling that, with all the corporate restructuring, this is a more competitive place," says Robert Hormats, vice chairman of Goldman, Sachs (International) & Co.

Role of Weaker Dollar

Economists also noted that the weakness of the dollar against several foreign currencies, especially the mark and the yen, also made it less expensive for some companies to manufacture in the U.S. than to export to the U.S. market. Further, "you look at other countries and most have large fiscal imbalances, more regulatory incumberances and more inflation," Mr. Hormats said.

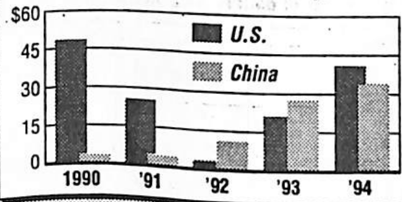
Some of the largest deals last year were foreign purchases of U.S. pharmaceutical companies. **Smithkline Beecham PLC** paid $2.93 billion for the over-the-counter drug business of Sterling Winthrop Inc., an **Eastman Kodak** Co. unit.

This year is likely to show an even larger investment flow into the U.S. Foreign direct investment "is on an uptick," says Richard Eberhart, an official with the international division of the Commerce Department. Already, the pace is ahead of last year's, because many deals announced in 1994 are just closing now. They include the acquisition of **Dow Chemical** Co. subsidiary Marion Merrell Dow Inc., a Kansas City, Mo., pharmaceutical company, by **Hoechst** AG for $7.2 billion, and the 20% acquisition of **Sprint** Corp. by **France Telecom** and **Deutsche Telecom** for $4.2 billion.

Despite China's fall to No. 2 in foreign direct-investment inflows, the $34 billion it garnered from around the world was more than 20% ahead of the previous year and more than twice the inflow of 1992. China's new openness to capitalism – and projections that its population will increase by one-third, to 1.6 billion, by 2050 – have served as a magnet to outside direct investment.

Foreign Direct Investment

Foreign Firms Put U.S. Back on Top...
Foreign direct investment in each country, in billions



While U.S. Firms Gain in Asia
Share of foreign direct investment in Asia

	1980	1993
Japan	24.0%	11.7%
U.S.	3.9	7.2
European Union	4.8	3.9

Source: United Nations Conference on Trade and Development

Total foreign direct investment in developing countries totaled $80 billion, twice as much as in 1991 and six times the average between 1982 and 1986. The U.N. dollar figures aren't adjusted for inflation.

Developing countries are "where the action is," said Karl Sauvant, chief of transnational corporation research at the United Nations Conference on Trade and Development in Geneva.

Strong Showing by U.S. Firms

As foreign investors were putting more capital into the U.S., American investors continued to make huge investments outside the U.S. For the third straight year, U.S. companies were the world's largest investors beyond their own shores, investing $56 billion around the world compared with $58 billion in 1993. The U.S. had lost its place as the lead international investor to Japan in the late 1980s, but regained the title in 1992 as U.S. companies poured money into the newly emerging Asian markets, especially China.

Mr. Sauvant says the growth of foreign direct investment to the developing world stems from liberalization of investment laws and advances in telecommunications and transportation that allow companies to manage integrated production world-wide. "They can make parts in different countries, assemble them in another country and then send them elsewhere," Mr. Sauvant says. In addition, as more and more companies set up manufacturing operations abroad, "competition makes you do the same," he says.

Many of the largest corporate investors in Asian countries are from other Asian countries, the U.N. research shows. That is helping to make the area more of a regional powerhouse and give it an increasing share of the world investment flows.

While foreign direct investment in Latin American and Caribbean countries has jumped from an average of about $6 billion a year in the early 1980s to an estimated $22.1 billion in 1994, its share of the world total has dipped a bit, to 10.8%. On the other hand, Asian countries (excluding Japan) accounted for 26.5% of the

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Investment in U.S. By Overseas Firms Nearly Doubled in '94

Continued From Page A2

world total, up from 9.8% in the early 1980s.

Executives at U.S. firms say they will continue to prefer Asian investments in the years ahead. In a recent survey of large companies planning international expansions, Deloite Touche Tohmatsu International found that 37% cited Asia and 27% cited Western Europe as the markets where they would concentrate.

A study last fall by Ernst & Young International Ltd. found that U.S. companies' investments in Asia and the Pacific region are in the form of joint ventures with Asian companies rather than acquisitions of existing operations. In the rest of the world, however, acquisitions were the favored investment vehicle by U.S. firms. The top industries they favored for investments were chemicals, pharmaceuticals, food, beverage, electronics, electrical and industrial machinery (including computers,) the study said.

As for the factors that draw U.S. firms to foreign countries, the Bureau of Business Research at American International College in Springfield, Mass., reported earlier this month that political stability was more important than stability of a country's currency or whether the country holds free general elections. Also, "contrary to popular belief, the wage structure of the country is relatively unimportant," the college found. It rated the availability and skill of the local work force well above wage structure in importance.

According to the U.N.'s latest count, for 1993, the book value of foreign direct investments in 207,000 foreign affiliates by 38,000 parent firms totaled $2.1 trillion. The affiliates had $5.8 trillion in sales in 1992, which was $1.1 trillion more than the world-wide exports.

WSJ
p A2

Balanced-Budget Measure Threatened By Rift Over Best Way to Cut Deficit

By Christopher Georges
Staff Reporter of The Wall Street Journal

WASHINGTON—With a scheduled vote on the balanced-budget amendment fast approaching, one basic quarrel threatens its passage.

The outcome could determine whether the deficit is reduced exclusively by spending cuts or by both spending cuts and tax increases. It could also help decide whether the greatest burden of wiping out the deficit will fall on upper-income Americans or on the poor and middle classes.

Of the two versions of the amendment now working their way through Congress, one — featured as part of the Republican "Contract With America" — would require a three-fifths majority vote in both houses of Congress to pass tax increases. However, spending cuts would require only a simple majority.

That tax-limiting version passed the House Judiciary Committee earlier this week by a 20-13 vote is on its way to the floor for final vote. But the Clinton administration, which opposes the tax-limiting bill, fired back yesterday with a study predicting that the states would forfeit more than $240 billion of federal aid in 2002 if that version becomes law.

Without the three-fifths provision, its supporters say, Congress would be tempted to balance the budget simply by raising taxes, rather than by making hard choices to spend less.

"Without it, we end up with an imperative to raise taxes," says Louisiana Democrat Rep. Billy Tauzin, a co-sponsor of the tax-limitation version. "I don't think the people would look too kindly on that."

But opponents of the three-fifths provision are just as quick to invoke the will of the people. A three-fifths provision, they counter, would lay most costs of the amendment on the middle class and poor, who constitute the bulk of the population.

That's because those Americans get most of their benefits directly from government programs, ranging from food stamps to Medicare. Upper-income Americans, on the other hand, get most of their benefits via tax breaks, such as deductions for property tax and charitable contributions.

The three-fifths provision would require a supermajority to eliminate or curtail these benefits, as well as to raise taxes.

Of course, middle-income Americans also enjoy many tax breaks. But according to an analysis by the congressional Joint Tax Committee of nine popular ones, the richest 10% of taxpayers get 46% of total benefits. Meanwhile, the bottom two-thirds of federal income tax payers receive only 26% of all benefits. The breaks studied by the committee included deductions for mortgage interest, property taxes and medical expenses.

"If Congress is serious about cutting the deficit fairly, they'd stay away from this proposal," says Iris Lav of the Center on Budget and Policy Priorities, an advocacy group.

To dramatize the effects of balancing the budget through spending cuts only, the administration yesterday released its predictions about what the amendment's state-by-state impact would be. It showed, as expected, that larger states such as California, New York, Texas and Florida would be hit hardest, with each losing at least $12 billion in aid. Most cuts, it assumed, would come from federal spending on health care and welfare.

While budget experts agreed with the administration's broad conclusions — that the states would be hit hard by overall cutbacks — they questioned the Treasury's ability to predict the state-by-state impact. It's too soon to tell, they said, which programs would be cut and by how much.

Economists also noted that the Treasury analysis failed to account for possible economic benefits of a balanced budget, such as lower interest rates.

Even so, supporters of the three-fifths rule don't deny that the provision could cut more heavily into programs aimed at the poor; they embrace it. "Spending on the poor has not helped the lower class; it created it," says Milton Friedman, an economist at the Hoover Institution and an advocate of the supermajority rule.

But opponents of the three-fifths provision add another argument: Fiscal policy shouldn't be a constitutional issue. "The Constitution has never contained any bias with respect to either spending or taxes," says Henry Aaron, a budget expert at the Brookings Institution. "Why it should now has never been fully explained."

No one, of course, can predict how Congress will act in the future, but one example of how a supermajority rule might be used comes from California. There, the state constitution requires a two-thirds majority vote in the Legislature to raise taxes. As a result, legislators have found it much easier to reduce spending than to increase revenues.

In recent years, the state government, faced with multibillion-dollar deficits, slashed spending deeply but made only a token effort to pare tax breaks. For fiscal years 1992-93 and 1993-94, California cut spending by $5.6 billion as part of an $18 billion deficit reduction. Over the same period, cuts in tax breaks totaled only $600 million, or 3% of the budget reduction.

Back in Washington, the two sides are digging in. "I will not accept anything that does not have a tax-limitation provision," House sponsor Joe Barton, a Texas Republican said.

Hit Hardest

States that Treasury says would suffer largest cuts from projected federal aid under balanced-budget amendment

STATE	SPENDING CUTS* (in billions)
California	$28.03
New York	19.24
Texas	14.93
Florida	12.44
Pennsylvania	11.61
Illinois	10.11
Ohio	8.83
Michigan	7.47
Maryland	7.38
New Jersey	7.13

*Cuts from spending projected for fiscal year 2002

Note: Assumes no cuts in defense spending or Social Security and no tax increases. Excludes possible economic benefits of balanced budget, such as lower interest rates.

Source: U.S. Treasury

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Dollar Darwinism

Global Capital Crunch Is Beginning to Punish Some Weak Economies

Mexican Crisis Was the Spark But the Effects Are Felt From Asia to Sweden

Money Seeks Safest Harbors

By MICHAEL R. SESIT
Staff Reporter of THE WALL STREET JOURNAL

LONDON — The global financial squeeze is on, and many developing countries are feeling the crush.

With most economies either expanding or starting to pick up steam, demand for capital is ballooning faster than investors can supply it. Able to be choosy, investors are becoming more selective about which world markets they want to be in or not be in. That's why markets in many developing countries — and in a few developed ones—are being clobbered.

"Investors are demanding a higher risk premium, and we have a crowding out" spreading like a virus in a crowded room, says Wolfhard Graetz, chief investment officer for Bank J. Vontobel Co. Group in Zurich. "If you have an epidemic, the weakest will be affected first. I won't say they will die, but they will suffer while the strong organisms will get through it much better. That is what is happening now in financial markets."

Mexican Markets Rebound

The peso rose 1.06% and Mexican stocks finished the day higher, in part because of comments by President Clinton that greater U.S. financial support would be available if necessary. See article on page A6. In other developments:

- **Some speculators say 'Brady bonds' market may be near the bottom, C1.**
- **Buyers of American depositary receipts get a lesson in risk, C1.**
- **Peso devaluation forces auto makers to alter production plans, A10.**

Having emerged from a year in which most of them fared badly, investors and traders world-wide have become more risk-averse. They are more concerned about nations with too much debt and less forgiving of nations with poor economic policies. The targets of their disappointment—or wrath, in some cases—are Latin America, Sweden and several South European countries. Asia's emerging markets have also been hit this year, but so far most of them are considered more the victims of dour sentiment than of poor policies.

While the widespread problems — large budget and current-account deficits and over-reliance on foreign capital — have long been evident, "Mexico was the wake-up call," says James Lister-Cheese, an international economist at Independent Strategy, a London consulting firm.

On Dec. 20, Mexico sent shock waves through global markets when it unexpectedly devalued its peso 15%. One day later, it let the currency float. The resulting 39% drop in the currency roiled the Mexican stock and bond markets and triggered huge losses in foreign — especially American—investors' portfolios. Since Jan. 1, the Mexico City Bolsa is down 29%, measured in U.S. dollars.

Spreading Ripples

But the reverberations spread much further as stock markets from Buenos Aires to Bombay tumbled, local bond markets crumbled, and currencies fell. In Latin America, Brazil's stock market has plunged 26% since the start of the year, measured in U.S. dollars, and Argentina and Peru are down 19%. Shaken by the Chechen conflict, investors are dumping Russian debt securities, too.

Suddenly, investors have been alerted to the problems that many emerging and the peripheral industrial countries will have servicing their debts.

"Mexico symbolizes the trend that in 1995 there is going to be a clear differentiation between those countries which will put in place the right macro- and micro-economic policies and those that don't," Mr. Lister-Cheese says. "Clearly, Mexico's balance-of-payments imbalance is indicative of the wrong policies and has led foreign investors to speculate whether there are other countries which will fall in that trap."

Drawing More Distinctions

He adds that people are beginning to appraise risk differently. Instead of throwing money blindly at all emerging markets, they are realizing that some emerging markets will "submerge" while others grow. "And it's not just the emerging markets that are feeling the brunt," he notes, "but also those industrial countries which are perceived as high risks because of their big fiscal imbalances: Sweden, Italy, Canada, Spain."

The current malaise had its roots early in the decade, when sluggish growth in the U.S. and recessions in Europe and Japan sent investors hunting for higher returns in the world's emerging stock and bond markets. From 1990 to the end of 1993, U.S. investors alone purchased a net $127 billion of stocks in 10 Asian and nine Latin American stock markets, according to the Securities Industry Association.

They were well rewarded. In 1993, for instance, the Philippines market surged 133%, measured in U.S. dollars, while stock markets in Hong Kong, Indonesia, Malaysia, Thailand and Brazil roughly doubled in value. The world's best-performing stock market was Poland, up a staggering 718% in dollar terms. Turkey was next at 214%. Zimbabwe soared 123%.

But "starting in 1994, we had strong

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A Tough New Year in Many Stock Markets

Percentage change in each country's stock market in U.S. dollar terms

	% CHANGE SINCE 12/30/1994*
THE AMERICAS	
Argentina	−18.6%
Brazil	−25.5
Canada	− 1.3
Chile	− 6.4
Mexico	−28.9
Peru	−18.8
Venezuela	+ 0.4
EUROPE	
Greece	− 0.3
Italy	− 2.3
Portugal	− 0.4
Spain	− 3.9
Sweden	+2.2%
Turkey	−7.6
ASIA	
Hong Kong	−8.2
India	−6.5
Indonesia	−4.9
Malaysia	−4.9
Philippines	−4.8
Singapore	−4.1
South Korea	−3.6
Taiwan	−5.1
Thailand	−2.6

*Through Jan. 10, 1995

Sources: Datastream International, Tradeline International

Dollar Darwinism: Capital Crunch Begins to Punish Weak Economies

Continued From First Page

growth in the U.S., a recovery in Europe and a bottoming-out of the recession in Japan, fueling credit-demand growth in the industrial world," says Marc Faber, who heads his own money-management and advisory firm in Hong Kong. "As a result, liquidity conditions began to tighten."

The emerging world's problem was that as it expanded, it became more and more dependent on foreign capital. The emerging countries' current-account deficits — a broad measure of trade in goods and services and financial flows, such as debt payments to foreigners — were growing.

"There wasn't enough capital to finance everything. And that brought about a choice among different emerging economies: Latin America, Asia, Eastern Europe," Mr. Faber says. "When the first signs of problem in Mexico emerged, there was a capital outflow from Mexico," an outflow that within days "became a crisis of confidence and a sobering-up period among emerging-market investors. The realization is beginning to sink in that the industrialized nations with their still-very-large budget deficits don't have a sufficient savings pool to finance growth everywhere in the world."

Rosy World Outlook

Overall, nevertheless, he and others say the world economic outlook is rosy. Although the U.S. economy is expected to slow, it is still growing strongly. Europe's recovery appears to be much more solid than many forecasters had expected, and Japan is showing signs of rebounding. With the opening of China and economic liberalization in India — the world's two most populous countries — as well as the collapse of communism, "hardly ever before has the global economic outlook been as positive as now," Mr. Faber says.

But, he warns, "There's always a bottleneck somewhere; the only constraining factor to this wonderful outlook for economic growth in the next five years is the scarcity of capital."

So far this year, investment that is leaving the beleaguered developing countries and Europe's weaklings is flowing to countries that show they can maintain low inflation and control their budget deficits, mainly Germany and Japan.

What's more, major world stock markets are regaining favor. "In the competition for funds, the developed world's economies aren't as unfavorable as they had been," says Anne M. Tatlock, president of Fiduciary Trust Co. International in New York. "One reason you are getting all this pressure in emerging markets is that a lot of people who didn't like the developed world and didn't believe you'd see good earnings and growth in Europe and Japan are now becoming more favorably inclined towards those regions."

For instance, James M. Connors, the international head of futures and options at FTC Ltd., a London-based trading and consulting firm, is betting that the Nikkei index of 225 major stocks that trade on the Tokyo Stock Exchange will rocket 23% to 24,000 by the end of June.

One reason is technical: He notes that in each of the past three years, the index hit its lows in the fourth quarter and highs in the second quarter of the following year. The other is political. "Now that Japan has agreed to open its financial industry more to U.S. institutions, I expect to see increased American investment in their markets," he says. Japan last year had the world's best-performing major stock market with a gain of 8.3% in yen and of 21.4% measured in dollars, according to the Dow Jones World Stock Index.

To some observers, global political instability is as responsible for roiling financial markets as the reverberations from the peso's plunge. Although Norbert Walther, chief economist for Deutsche Bank AG in Frankfurt, doesn't view the situation as irreparable, he complains: "In broad political terms, we have one superpower left, and that superpower isn't willing to be a world leader. And no other country or organization is taking up this role."

The German economist argues that much of the onus rests with the U.S. "It involves the U.S. president getting back on the international stage, showing he cares about international institutions such as the World Trade Organization, expressing concern about Europe and settling the U.S. dispute with Japan," he contends. Noting the seemingly endless war in Bosnia, Russia's invasion of Chechnya and strife elsewhere in the former Soviet Union, he adds: "Europe even doesn't take care of its front yard or its back yard."

The Need in Europe

If President Clinton does move to resolve some of the problems, the dollar might rise, especially against the yen, and Japan's economy might recover from the strong yen's devastating effects, Dr. Walther believes. He adds that maintaining healthy world securities markets requires that Japanese investors renew their appetite for foreign stocks and bonds. There are recent signs they have begun to do so.

Dr. Walther also says Europe needs a strong leader to champion the stalled push for European integration. "That person is [German Chancellor Helmut] Kohl, but for domestic reasons he doesn't seem that interested in that right now," he says. "It frightens me, because it shows that even a country like Germany doesn't understand the importance of European integration or freedom and wealth." If Japan and the West don't get their acts together, Dr. Walther fears, "we may end up with something that is closer to protectionism than the rule of law."

Meanwhile, the tumult in Latin American markets is stirring fears that foreign investors might bolt Asia's emerging markets. Brokers say foreigners figure prominently among the investors that have driven Hong Kong's stock market down 8.2% in dollar terms this year.

Unfounded rumors have begun rattling Southeast Asian markets. Gossip that Hong Kong and China's credit ratings were about to be downgraded as well as rumors that Chinese leader Deng Xiaoping had been hospitalized contributed to Hong Kong's 2% fall yesterday. Other speculation focused on the vulnerability of the Hong Kong dollar in the face of a large outflow of foreign funds from Hong Kong investments. Similar rumors, inspired by Mexico's devaluation, have washed through the currency and equity markets of other Asian countries.

In Eastern Europe, Russia's messy invasion of Chechnya is prompting many investors to unload everything from Russian debt to Czech stocks. "Mexico and its devaluation is the lead story," says Richard Segal, a Bank of America economist in London. "But Russia and its Chechen crisis is close behind."

Prices of government and other bonds issued by Central and East European countries have plummeted in the past week, with prices tumbling 4% to 6% in the past few days alone. Since Dec. 10 — before Mexico devalued the peso and the Chechen war began — Russia's dollar-denominated bonds have declined nearly 40%. That makes them the worst-performing assets in the world over the past month, according to Robin Hubbard of Paribas Capital Markets Ltd. in London.

Some Opportunities Spotted

Some traders say the shock waves could continue for at least a few more weeks as some frightened American mutual-fund investors, already badly burned in 1994, might cut and run from emerging markets. Even though many professional portfolio managers are exiting, some see opportunities in the emerging-market debacle. "I will invest, especially in Latin America where we will have bargains again," Vontobel's Mr. Graetz says.

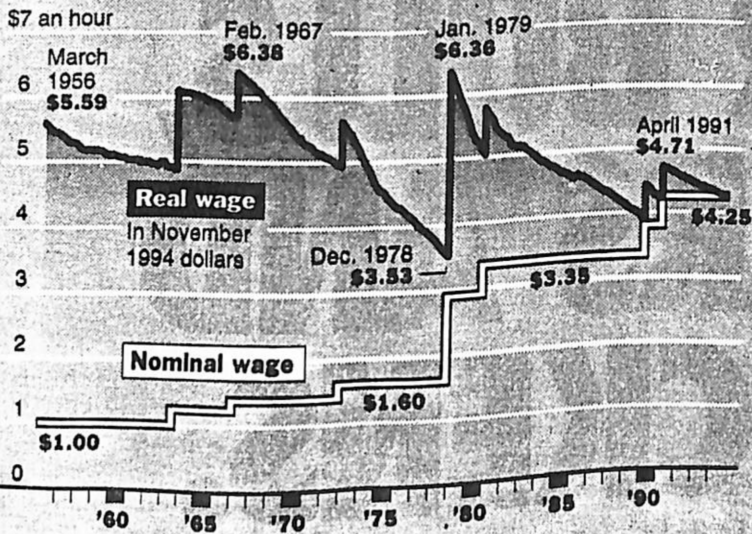
He already is contemplating buying shares in Telefonos de Mexico, the communications giant whose American depository receipts yesterday closed $2 higher at $35.375 each but are still near their 12-month lows. "The key to successful investing in emerging markets is to buy them when nobody wants them and to sell when everyone is prepared to give you his last shirt for some equity in Latin America, Africa or wherever," Mr. Graetz says.

Yesterday, signs of tranquillity began to return to some Latin American securities markets. "There's a sense of calm that while the problems may not be over, the worst — the panic selling and forced liquidations — has stopped," said the head of emerging-market debt trading at a big Wall Street firm. "Bottom fishers have started to appear; junk-bond specialists began crawling in last week."

But more storms could still develop. "Next to liquidity, we have a lack of confidence in the ability of governments to pay back their debt," Mr. Graetz says. "It's apparent in Sweden, in Southern Europe and in Latin America."

—Glenn Whitney in London and Matthew Geiger in Kuala Lumpur, Malaysia, contributed to this article.

7: D1+D19 WSJ 1/12/95



What the Lowest-Paid Are Paid

The Federal minimum wage in nominal terms and in terms of today's money. Job categories covered by the minimum have varied over the years; some states set higher minimums. Figures are plotted monthly and are adjusted for inflation based on the consumer price index (seasonally adjusted starting in 1972).

Source: Datastream

The New York Times

Minimum Wage and Jobs

Economists Are Finding a Smaller Threat Of Dismissals After Legislated Pay Rises

By LOUIS UCHITELLE

News Analysis

The Clinton Administration, which appears to be advocating a higher minimum wage as one of its major policy objectives, is doing so at a time when most economists find less damage from raising the minimum wage than they once did.

A chief argument against raising the minimum wage, among both economists and politicians, is the fear of job losses. The threat is that employers will dismiss thousands of workers on the ground that they lack the skills to be worth more than the minimum wage, which is $4.25 an hour. But nearly all these estimates of job losses have shrunk as research continues.

"The main thing about this research is that the evidence of job loss is weak," said Robert M. Solow, a Nobel laureate in economics at the Massachusetts Institute of Technology. "And the fact that the evidence is weak suggests that the impact on jobs is small."

That does not quiet the debate. The new Republican leaders in Congress have vowed to reject any bill to raise the minimum wage, invoking the prospect of job losses as the chief reason. Representative Dick Armey of Texas, House majority leader, said last week that he not only opposed an increase in the minimum wage, but would also like to repeal the law.

Still, Vice President Al Gore and the House minority leader, Richard A. Gephardt of Missouri, in recent appearances, have publicly supported a higher minimum wage. President Clinton may endorse the move this week or next. He said yesterday that he was awaiting a recommendation from his advisers.

"Lifting the minimum wage is one of several major initiatives designed

Continued on Page D19

Minimum Wage Rise Cause for Dismissals

Continued From First Business Page

to lift the wages of all working Americans," a senior Administration official said. He ranked its importance with the President's recent tax cut proposals for middle-income families.

For all the political controversy surrounding the minimum wage, economists who study the issue have managed to agree on several key findings. These agreements help to explain why the minimum wage debate, as Mr. Gephardt put it, has become "a metaphor for the differences between Democrats and Republicans."

Contrary to popular wisdom, for example, economists have found that only one-third of the roughly four million minimum-wage earners are teen-agers. The rest are adults over 25, a significant number of whom — some say as many as 45 percent — provide nearly half of their families' incomes. Raising the minimum by 75 cents an hour, the amount under discussion in the Administration, would bring a gain in living standards, but only for those who do not lose their jobs.

Economists have also found that raising the minimum wage produces a net gain in total income. That is, the total income growth for minimum-wage workers who keep their jobs exceeds the income lost by those who lose theirs.

The gains in income, for some economists and politicians, can thus outweigh the loss in jobs. "If your objective is to make work pay well enough so that it takes fewer wage earners in a family to keep the family out of poverty, then raising the minimum wage is a worthy goal," said Henry J. Aaron, an economist at the Brookings Institution.

That is a goal mentioned by Administration officials. But for many Republicans and for Finis Welch, a labor economist at Texas A & M University, saving jobs should be the higher priority. "We are in effect telling unskilled people that if they are not worth the wages we set, they cannot work," said Mr. Welch, who added that he believed most employers would do little to train low-skilled workers so they could become more valuable and eventually worth the higher minimum wage.

But Mr. Welch and other economists agree that a higher minimum wage tends to lure people out of idleness and into jobs by making work more valuable than, say, the alternative of government welfare programs. As a result, the cost of low-income workers shifts a bit to business from the public sector.

Finally, there is agreement that a higher minimum wage has a ripple effect, pushing up wages for those earning up to 50 cents above the old minimum. More than 5.5 million workers, or nearly 5 percent of the workforce, receive wages within 50 cents of the minimum, which rose to $4.25 in 1991 from $3.80. That's one reason, among several, that business regularly opposes increases in the minimum wage.

Yet the principal battle cry against raising the minimum wage — job losses — is no longer as powerful an argument as it once was. A decade ago, most studies concluded that 1 percent or more of all minimum wage workers lost their jobs for each 10 percent increase in the minimum wage. The most recent studies put the job losses at less than 1 percent, or roughly 40,000 people if Congress were to increase the current minimum by 75 cents, a jump of nearly 18 percent.

Some studies go even further. Two Princeton University economists, David Card and Alan Krueger, contend that there is little evidence of any job loss at all from increasing the minimum wage. Mr. Krueger recently became chief economist at the Labor Department, where he is an adviser to Robert B. Reich, the Secretary of Labor and a principal advocate within the Clinton Administration of lifting wages at the low end of the job ladder.

Estimates of job losses from higher minimum pay are reduced.

By contrast, Professor Welch at Texas A & M insists that the traditional view about job loss is still correct. His new study, done with two colleagues, Donald Deere of Texas A & M and Kevin M. Murphy of the University of Chicago, was made public last Sunday at the annual meeting of the American Economic Association in Washington. It estimated that each 10 percent rise in the minimum wage between 1989 and 1991 produced job losses of at least 1 percent of all minimum wage workers, or roughly 60,000 people if the minimum is raised by 75 cents.

Alone among the most recent studies, said Charles Brown, a University of Michigan labor economist, "the Welch findings go back to an older thesis that there was a bigger job impact when the minimum wage rose."

President Clinton promised, during the 1992 election campaign, to raise the minimum wage. But he took no action while he pursued a health insurance bill. Now Administration officials argue that raising the minimum, which has lost a third of its purchasing power since 1979, would help narrow the wage gap between low- and middle-income workers.

Professor Solow of M.I.T. agrees. "When the minimum wage has deteriorated so much in purchasing power," he said, "there are probably enough people who would be worth the higher wage and would not lose their jobs."

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Conservative, Pro-Business Think Tanks Take Center Stage Before House Panel

By David Rogers
And John Harwood
Staff Reporters of The Wall Street Journal

WASHINGTON—The House Appropriations Committee began its long budget-cutting march by granting unparalleled access to conservative, pro-business think tanks that are asking Republicans to make major reductions in government programs.

An opening hearing yesterday was dominated by testimony from the Cato Institute, Heritage Foundation and Citizens for a Sound Economy. And the lineup of witnesses—sitting across from dour lawmakers – dramatized the increased influence of these corporate-backed groups with the Republican takeover.

The committee's new chairman, Rep. Bob Livingston (R., La.), taking in the sight of so many conservative witnesses in the once-Democratic panel, commented, "It is historical, not hysterical."

"Some of both," added Rep. Ralph Regula (R., Ohio), after being told by a Heritage witness to think like a "Fortune 500" executive and cut the Energy and Interior Department budgets in his jurisdiction by 50% over the next five years.

Stephen Moore, a Cato director with past ties to House Majority Leader Richard Armey, called for an immediate across-the-board sequester to reduce spending by 3% in the second half of this fiscal year ending Sept. 30. The net savings, about $16 billion, would include an estimated $4 billion from prior defense appropriations, and Cato's willingness to demand cuts from Pentagon accounts sets it apart from many in the GOP.

Distance From Business, Too

Though most of the focus is on the House, Cato proposals show up in working documents used by Senate Budget Committee Republicans charged with identifying spending cuts this year. And for all the corporate ties to the various think tanks, the witnesses yesterday seemed to delight in setting themselves apart from what one described as the old GOP image of being only "legislative adjuncts of the National Association of Manufacturers."

Jerry Taylor, Cato's director of natural-resource studies, said much of the government's research budget amounts to "corporate welfare" and suggested that public lands, including the national forests, would be better sold to the private sector or turned over to nonprofit organizations such as the Audubon Society. This provoked Rep. Charles Taylor (R., N.C.), a strong ally of the timber industry, to suggest the witness might have been "smoking a little funny weed somewhere." And when a Heritage representative proposed that visitors to the Capitol might be charged $1 for upkeep, even Cato's Mr. Taylor moved back from from his pure-market ways and dissented from the proposal.

Citizens Against Government Waste, founded in the aftermath of the Grace Commission cost-cutting report in the early 1980s, joined in the testimony. But the think tanks, with their corporate ties, best illustrated the increased role of pro-business interests since the November election.

Other Joint Efforts

The small-business lobby, which is even more favored by Republicans – and openly partisan – than are large corporations, joined with the House GOP leadership in a press conference yesterday on term limits. And in the same vein, Citizens for a Sound Economy will use Rep. Joe Barton (R., Texas), the new chairman of the House Commerce oversight subcommittee, as a vehicle to announce the results today of a survey funded by the group to advance its agenda of regulation reform at the Food and Drug Administration.

In other developments:

- Ending days of maneuvering, the full Senate voted 98-1 to make Congress more subject to the laws its passes. The one dissenting vote was Robert Byrd (D., W.Va.). Similar legislation already has passed the House. While lawmakers still would be exempted from provisions of the Freedom of Information Act, the legislation would bring members and their offices under fair labor standards and antidiscrimination statutes.
- The House Judiciary Committee pushed toward approval of a proposed amendment to the Constitution requiring a balanced budget by the year 2002. But Republicans acknowledge that they will face opposition on the floor to a provision requiring a three-fifths majority for future income-tax increases. Instead, a second version of the same amendment, requiring a constitutional majority of 218 votes in the House and 51 in the Senate for tax increases, is now favored in the debate later this month.

While moderate and conservative Republicans debated competing budget-balancing proposals, Democrats underscored their own internal divisions. Chiding "new Democrats" for abandoning President Clinton's agenda, Sen. Edward Kennedy (D., Mass.) urged colleagues to resume the drive for comprehensive health reform and rejected the GOP's "mindless antigovernment vendetta" against federal regulation. "The task of a great political party is to face the tide, not just ride with it," the liberal stalwart declared in a National Press Club speech.

But hours later, the leadership announced the appointment of Sen. Robert Kerrey of Nebraska, one of the new Democrats who has most distanced himself from the administration, as chairman of the party's Senate campaign committee for the 1996 elections.

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Clinton's Plan to Raise Wages Draws Opposition Before Details Are Presented

By RICK WARTZMAN
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON — Even before President Clinton proposes raising the minimum wage, sharp battle lines are being drawn over the issue.

Mr. Clinton has yet to sign off on any specific plan, but it's all decided that he will seek an increase in the pay floor from the current $4.25 an hour.

The president struck a generally positive tone on the subject yesterday, telling reporters that "the No. 1 mission of the country in this recovery is to raise incomes." Mr. Clinton noted that his economic advisers haven't yet sent him a formal recommendation on the minimum wage, but said that when they do, "I will seriously consider" it.

One leading option being kicked around by the president's advisers would boost the base wage by 50 cents an hour, essentially making up for the inflation that has occurred in the four years since it was last increased. The administration would then call for another boost of 25 cents to take effect about a year later, lifting the minimum wage to $5. Also being strongly considered is a proposal to alter the law so that the minimum wage automatically rises to keep up with inflation, just as government benefits such as Social Security do.

Some 2.5 million hourly workers are paid the federal minimum wage, the Bureau of Labor Statistics estimates. An additional 1.7 million hourly workers, including some who receive tips and are covered by a different standard, are paid below the $4.25 level.

Administration officials stressed that the details of their proposal are still undecided, as consultations continue with Democratic congressional leaders about how best to proceed.

Nonetheless, opposition groups already are gearing up to take on any proposal that emerges. During the debate over health-care reform last year, retailers, restaurateurs and small-business owners organized into a potent coalition that helped beat

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Clinton's Plan to Seek Minimum Wage Rise Gets Early Opposition

Continued From Page A2

back a White House proposal that would have forced employers to help pay for their workers' medical insurance. "If the administration lays a minimum-wage hike on the table, we're ready to join forces again," vowed Steve Pfister, a lobbyist at the National Retail Federation.

Meanwhile, the Republicans in charge on Capitol Hill are opposed to a higher minimum wage, with both Speaker Newt Gingrich and House Republican Leader Richard Armey coming out against it.

Conservative Democrats also express reservations. Rep. Charles Stenholm of Texas said he would like to see higher compensation for people earning the minimum wage, but thinks it must be done in the context of a broader package. The minimum wage itself, he suggested, "may in some cases need to be reduced in order to provide for job opportunities."

Fulfilling Campaign Pledge

Nonetheless, the White House feels that attempting to raise the pay floor will help distinguish its agenda from that of the GOP, demonstrate its compassion toward lower-income working Americans, and fulfill a promise Mr. Clinton made during his election campaign. It also seems popular. The latest Wall Street Journal/NBC News poll found that 75% of the public supports increasing the minimum wage.

In meetings over the past few weeks, the president's top economic advisers have reached a consensus that raising the minimum wage by the amounts being considered would have, at most, a small negative effect on employment. At the same time, they've concluded that such a move could have a very positive effect on the earnings of the working poor, without introducing a big new government program.

Much of this view is based on a series of economic studies that have been produced since the late 1980s, including works by Alan Krueger, the chief economist at the Labor Department, and his predecessor in that post, Harvard University's Larry Katz. Their research determined that among fast-food restaurant workers in states where the minimum wage has gone up, including Texas and New Jersey, there was no negative impact on job creation.

Restaurant Lobbyist

Yet the opposition already is trotting out its own analyses from university economists that try to poke holes in those findings. Some of these studies have been produced by the Employment Policies Institute Foundation, a think tank run by Richard Berman, a lobbyist with strong ties to Republican lawmakers. In his lobbying role, Mr. Berman represents several restaurant companies.

"An enormous amount of work has been done showing that the minimum wage is harmful," Mr. Berman said yesterday, especially among low-skill adults. He also maintained that there is "significant evidence" that a higher minimum wage will make it harder for many people to make the transition from welfare to the work force.

Some congressional Democrats, including House Minority Leader Richard Gephardt, have indicated that they'll fight for a higher minimum wage. But opponents hope to make something out of the fact that in 1977 Mr. Gephardt opposed an increase in the minimum wage. "The economics on the minimum wage haven't changed since his vote," Mr. Berman said.

Sanjay FYI Mark

THE EDITORIAL PAGE

FRIDAY, JANUARY 13, 1995

LETTERS

Budget straitjacket can't replace political will

Washington seems unable to let a bad idea die.

The first major issue to be discussed by Congress in 1995 was defeated last spring — a balanced budget amendment to the Constitution. The budget amendment is being offered as an economic and political tonic. In fact, however, it is a toxin in both realms.

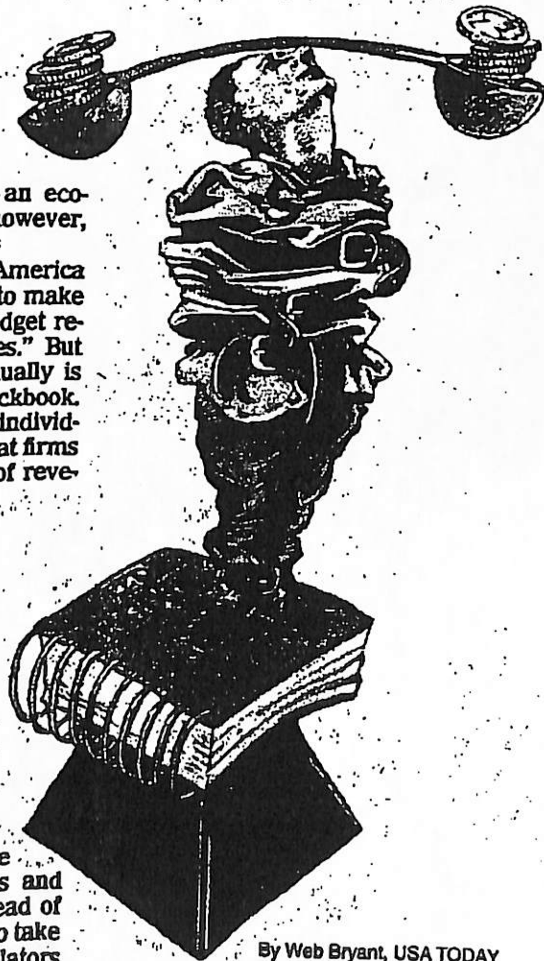
The Republican Contract with America argues the amendment is needed to make Congress "live under the same budget restraints as families and businesses." But balancing the federal budget annually is not the same as balancing a checkbook. Rather, it is like demanding that individuals pay cash for their homes, or that firms purchase an entire new plant out of revenue from one year's receipts.

The amendment also ignores a unique federal responsibility — stabilizing the economy. One reason we have avoided a depression since the 1930s is because our federal budget adjusts automatically to help offset private-sector slumps. A balanced budget would eliminate one of the few mechanisms preventing a mild downturn from developing into a severe economic crisis.

Politically, the amendment also threatens to distract us from the real task: setting national priorities and making difficult policy choices. Instead of focusing on a constitutional change to take effect in the next decade, legislators should work to lower our current deficit.

Besides, the amendment offers only a statement of intention. No budget balance can ever be achieved without political will. And if deficit spending continues, then what? Can you imagine letting a federal judge decide how we should balance the budget? Action on each budget would probably be tied up in the courts for years.

Yet another problem: All fiscal straitjackets can be stretched. The lesson from both state-level experience and the federal Gramm-Rudman deficit control experiment is that numerous evasions can and will be found. Imposing new mandates on corporations and state and local governments would be an especially attractive avenue open to federal officials.



By Web Bryant, USA TODAY

The frustration Americans feel toward our federal budget is understandable. Passing a balanced budget amendment might fill us with a sense of accomplishment for a short while. In the end, it will produce a more fragile economy, greater citizen frustration and a further loss of confidence in our political institutions.

Leave the Constitution alone. Let this bad idea rest in peace.

Charles J. Whalen, resident scholar
Jerome Levy Economics Institute of
Bard College, Annandale-on-Hudson, N.Y.

The Fight Over Orphanages

Welfare: Let's move to a discussion of what is best for the children that is open, honest and fair

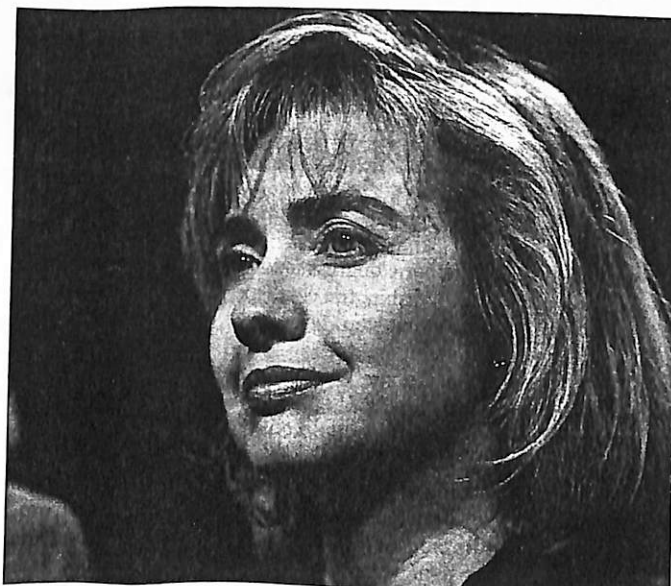
BY HILLARY RODHAM CLINTON

Hillary Clinton recently dismissed as "absurd" the idea of taking poor children away from their homes and putting them in orphanages. Newt Gingrich retorted by suggesting that the First Lady rent the 1938 movie "Boys' Town," adding, "I don't understand liberals who live in enclaves of safety who say, 'Oh, this would be a terrible thing. Look at the Norman Rockwell family that would break up.' The fact is we are allowing a brutalization and a degradation of children in this country, a destructiveness." NEWSWEEK *asked Mrs. Clinton for her response:*

I AM HEARTENED THAT the well-being of children and families increasingly is a focus of national attention as more and more Americans express their frustration with the failings of the welfare system, high rates of illegitimacy, irresponsible parenting, poor schooling, drugs and violence. And I applaud our nation's determination to do something about these problems.

Over the past 25 years I have spent a lot of time and energy working to strengthen families and help children. There is nothing about which I care more. I have volunteered in institutions serving children in homeless shelters, group homes, children's hospitals and schools. In Arkansas, I started programs to teach parenting skills to welfare recipients and worked with advocacy groups to improve education, health care and child care. I have served on committees to combat youth violence and child abuse. And I have written about the legal rights and responsibilities of children in their families and society.

I also understand the frustration that many Americans feel toward government bureaucracy. As a children's advocate and lawyer, I waged plenty of my own battles with government and represented foster children and parents in lawsuits against government bureaucracies. On a more personal level, I have struggled with the anguish caused by terminating the parental rights of mothers who desperately love their children but are unable to care for them. And I have had to explain to abused children, who fear loneliness more than harm, that being taken from the only home they know is for their protection and not their punishment.



LARRY DOWNING–NEWSWEEK

The First Lady: 'I doubt either mom would have given up Bill or Newt without one heck of a fight'

Based on these experiences, I know that when any of us talk about what is best for children, we should start with a large dose of humility, and then be willing to struggle through the hard questions posed by the collapse of families.

Take the orphanages debate, for example. There is no doubt that many Americans have benefited from being raised by caring people in orphanages. On the other hand, I disagree with those who suggest that children should be taken from their parents and put in orphanages solely because they were born out of wedlock and their parents are poor. This is big government interference into the lives of private citizens at its worst.

As we debate welfare reform, I hope we will learn from the recent verbal skirmishes over orphanages how public discussion of critical issues can be confused and bogged down by polarizing language. I agree with the recent comments of Speaker Gingrich, who said last week that the debate over orphanages had become distorted and cheap. Let's move on to a discussion that is open, honest and fair. If we do, perhaps we will be able to look back at the orphanage debate as a cautionary lesson in how to discuss sensitive and important matters, and not to characterize whole groups of Americans with broad, unfair stereotypes that will not lead us to positive or fair solutions.

Like most Americans, I too am deeply disturbed by the outrageous rates of out-of-wedlock births and the welfare dependency they bring. And my heart breaks every time I hear another story about a mother or father who abuses, neglects or kills a child.

But more than two decades of working on children's issues has taught me that there are no simple solutions to such complex human problems. I also have learned that there are some absolutely bedrock principles when it comes to ensuring the well-being of children.

First, children are almost always best off with their families. Our legal system presumes that a child should be with his or her parents unless there is convincing evidence that abuse or neglect threatens a child's well-being. That standard should not be changed. But we should look for better ways to identify children at risk, move quickly to help their families and, as a last resort, move children to the best possible out-of-home placement.

Second, those who believe poverty is a disqualification from good parenting probably have not been in the company of poor but hardworking parents. Both the President and the Speaker lost their fathers, one through death, one through divorce. Each of their young mothers eventually remarried, and each boy was then adopted by his new father. But one can only imagine what might have

happened if bad luck had left those young women alone and in poverty. I doubt either mom would have given up Bill or Newt to any orphanage without one heck of a fight.

Poor parents struggle every day to give their children the most with the least. And often they are among the best parents. They know children need a secure home, strong values, consistency and love. The love can be as rich and the values as sound in the homes of Watts as in Westchester, in Harlem as in Highland Park.

'Children are almost always best off with their families'

Those who think otherwise are letting a handful of sensational media stories create a false stereotype in their minds. After all, only a small fraction of the 14 million children classified as poor currently are placed in out-of-home care.

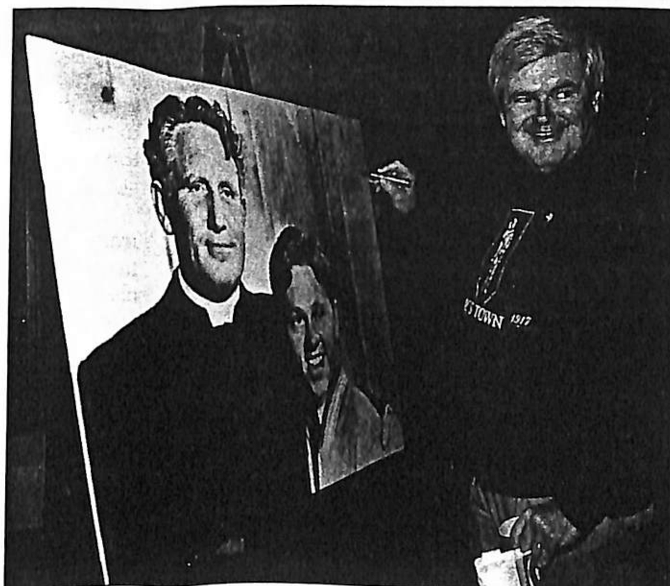
Third, it is important to support families with special problems, including poverty, before giving up on them. Certainly there are cases—too many, and tragically there seem to be more all the time—where parents abuse their children or are unable or unwilling to meet their family responsibilities. Instances of abuse and neglect occur in rich as well in as poor families. But we all know that poor families are more likely to feel the stress of economic troubles and be identified for government intervention. It is more cost-effective and realistic to help avoid family breakup. That is why the President signed the Family and Medical Leave Act, which enables parents to be good parents and good workers by giving them time off without fear of losing their job when a child is born or is sick.

The President also insisted in 1993 on giving working families earning less than $26,000 a year a tax cut that averaged $1,000 a family, so that their hard-earned dollars could be spent on their children instead of sent to the government.

The President's budget plan also included funding for family preservation programs like the one I recently visited in Los Angeles. That church-run program receives state and federal funds to help families stay together. The success stories I heard were impressive, and so was the fact that the work being done was cheaper than any foster care or orphanage could ever be.

Fourth, whenever dangerous circumstances do exist, children must be protected from harm and moved into alternative settings outside their family. But this should only occur as a last resort to keep the child safe.

When children are endangered and only the government has the right to intervene, government must act quickly and decisively to protect them. But removing children from their parents is—and should be—difficult because of the seriousness of the matter, and because available options outside the family are not always good ones. Too often, children are left to languish in the insecurity of the foster care system or with inadequate institutional care. When the government is forced to remove a child, it should be required to find the right solution promptly.



ROB NELSON—BLACK STAR

Promoting Father Flanagan: Gingrich autographs a photo from 'Boys' Town' at a Georgia screening

The point I have tried to make for years is that any decision to separate a child from his parents should be made solely on the basis of the child's safety and well-being. We should never permit children to be taken from their families simply because the parents are poor, unmarried or lacking education.

So let's put first things first. Our greatest energy should be spent promoting responsible parenting and independence from the welfare system—all with a view toward building strong families and creating conditions in which children can flourish. Children's welfare should always be the underlying principle in welfare reform. It is the crux of welfare reform legislation the President presented to Congress last year. And it is what the President was working for when he gave 24 states waivers to promote their own versions of welfare reform.

In the coming debate, I hope we can all agree to launch a national campaign to discourage teenage pregnancies and to require fathers to take responsibility for their children and pay child support when marriage doesn't occur or divorce does. We should insist that young men who casually father children admit paternity. We should help young women on welfare who are yearning to be good mothers acquire the skills they need to move out of welfare and into work. We should encourage the adoption of children who cannot be returned to their parents. We should insist that any institution we establish for children meet standards of care and safety that we would demand for our own children.

I grew up in a Republican family and, although I'm now a Democrat, I always thought the Republican Party believed in the value of family—not in government intrusions into family life. It is my hope that we can now put the war of words about orphanages and the slogans about welfare families behind us and join together—as parents, teachers, ministers, community leaders and policymakers—to fulfill our responsibilities to America's children. Too often in the past, we've assumed that only the family, or only the government, was responsible for ensuring the well-being of children. But personal values and national policies must both play a role.

As the National Conference of Catholic Bishops said in its 1992 pastoral letter entitled, *Putting Families First:* "No government can love a child, and no policy can substitute for a family's care. But, government can either support or undermine families. There has been an unfortunate, unnecessary and unreal polarization in discussion [about] how best to help families. The undeniable fact is that our children's future is shaped both by the values of their parents and the policies of our nation."

I have a feeling if Father Flanagan were here to take part in this debate, his view would reflect the wisdom of the bishops. Taking responsibility for the children in our own lives and all children is the most sacred duty we have. ■

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G.O.P. TAX PLAN MAY LACK SUPPORT

A 'Supermajority' Proposal Is Running Out of Steam

By MICHAEL WINES

Special to The New York Times

WASHINGTON, Jan. 12 — It is starting to look as if a major subparagraph of the House Republicans' "Contract With America" — one that is intended to make it almost impossible for Congress to raise taxes — lacks enough Republican support to survive.

And it now appears that a more moderate proposal, conceived and nurtured in part by conservative Democrats, has the best chance of winning House approval, and perhaps Senate approval, too, as part of the balanced budget amendment to the Constitution.

On a Capitol Hill day that Republicans devoted almost wholly to showcasing their agenda and feuding with Democrats, the politics of the balanced-budget amendment debate sounded a lone off-key note.

The House took the day off. The Senate met but spent the day in languid discussion of a Republican proposal to prevent states from bearing the costs of carrying out Federal mandates, and it took only procedural votes.

By contrast, the balanced-budget amendment was the object of maneuvering, as support appeared to diminish for the clause in the Republican leaders' version of their amendment that would require that

Continued on Page A22, Column 1

CONGRESSIONAL ROUNDUP

'Supermajority' Tax Plan May Lack G.O.P. Support

Continued From Page A1

all tax increases be approved by a three-fifths "supermajority." Current law requires only a simple majority of voting lawmakers to increase taxes.

When the House Judiciary Committee voted on Tuesday to approve a balanced-budget amendment, the supermajority requirement for tax increases was part of it. But in an interview, a senior Republican aide who spoke on condition that he not be named said that such a hurdle to future tax increases "ain't gonna fly" when the amendment reaches a House vote, later this month.

And Representative Charles W. Stenholm, a conservative Democrat from Texas, said today that he has secured the backing of at least 65 Democrats for an amendment with a lower barrier to tax increases.

That is significant because constitutional amendments require approval by two-thirds of each chamber of Congress, a number that Republicans cannot muster without at least 53 Democratic votes in the House. The Republican leadership's version of the amendment has little Democratic backing in either the House or the Senate.

Mr. Stenholm said today that his amendment "is the only one that's got a chance of passing" in the new Congress.

Republican leaders in the House stopped short of admitting that. But an aide to the House majority leader, Representative Dick Armey of Texas, said that lawmakers will get a chance to consider both versions of the amendment when the matter comes to the floor, and the most popular version will be adopted.

Mr. Armey told reporters on Tuesday that he "can live with" Mr. Stenholm's less restrictive version of the amendment, the newsletter Congress Daily reported today.

Mr. Stenholm's amendment, also sponsored by Representative Dan Schaefer, a Colorado Republican, would require an absolute majority of senators and representatives — that is, a majority of the total membership of each house — to approve a tax increase before it becomes law.

An identical measure was considered in both the House and the Senate in the last Congress, but failed to pass. The current version favored by the Republican leadership — the three-fifths version — is getting its first review. "A strong component of Democrats, and even some Republicans," oppose it, said Jane Guerrero, an aide to Mr. Schaefer.

"Some freshmen want the three-fifths," she said. "But the choice is our version, or no version, and the leadership agrees. Once the freshmen realize that's the lay of the land, we'll say it's what we can get."

Welfare

Representative Bill Archer, the Texas Republican who is chairman of the Ways and Means Committee, affirmed today that House Republicans wanted to end welfare and food stamps as entitlement programs, which pay benefits to anyone who meets certain eligibility criteria. "We will end entitlements as we have known them," he said.

The Republicans want to replace them with lump sums of money, paid to the states as block grants.

Mr. Archer and Representative E. Clay Shaw Jr., chairman of the subcommittee that will begin considering welfare legislation on Friday, said that they still wanted to make immigrants ineligible for Federal aid under Medicaid, welfare, school lunch programs and other programs.

Republicans proposed such a prohibition as part of their Contract With America. The prohibition would apply to legal and illegal aliens. House Speaker Newt Gingrich said recently that he was reconsidering the proposal. But Mr. Shaw, a Florida Republican who is chairman of the Ways and Means Subcommittee on Human Resources, said he did not take Mr. Gingrich's "offhand comment" as an instruction to revise the legilsation.

At a hearing of the Ways and Means Committee today, two Republican Governors, George E. Pataki of New York and William F. Weld of Massachusetts, praised the tax and welfare proposals in the contract. Mr. Weld said he was willing to accept less money from the Federal Government for welfare programs if he had more flexibility in running the programs.

But Gov. Howard Dean of Vermont, a Democrat, expressed concern, saying that "kids will be the victims" if they lose their entitlement to welfare benefits. "In the next recession, children will be the ones in trouble," said Mr. Dean, who is chairman of the National Governors' Association.

Line Item Veto

The Republican effort to give Presidents their first-ever veto over individual items in Federal spending bills — a proposal the White House supports — got decidedly mixed reviews from a dozen politicians, budget analysts, anti-waste muckrakers and other experts.

Senate and House committees are considering bills that would effectively give a President control over even the smallest Federal expenses by allowing him to simply wipe unpalatable spending items out of budget bills after the legislation has been signed into law. Both versions would also let the President delete special-interest tax breaks from tax bills.

In both cases, what would follow amounts to a political pas de deux: The Senate and the House of Representatives would have a limited time (20 days in the House version) to restore the repealed expenses by a majority vote; the President could veto that restoration, and each house would then have to override the veto, by a two-thirds vote, to keep the spending items intact.

Politicians and officials of government-watchdog groups generally liked it. Senator John McCain, Republican of Arizona, said studies show that Congress has larded military-spending bills with $50 billion in non-military spending over the last six years, and he argued that a line-item veto would help put a stop to it.

Representative Michael N. Castle of Delaware, a Republican who not long ago was that state's Governor, said he had used such a veto to stop the Delaware Legislature from increasing the traffic-light budget five-fold.

Governor Weld testified that he had wielded the line-item veto in his state more than a thousand times, mostly to cut pork-barrel spending put in legislation to win someone's vote.

Forty-three-states have some form of line-item veto; the former Governor of Arkansas, Bill Clinton, used it 11 times during his tenure.

Amid all the fervor, however, even supporters sounded some cautionary notes.

The White House budget director, Alice M. Rivlin, testified that President Clinton supports legislation giving him the broadest veto power o. spending that Congress can devise — or, roughly, what the present bills contemplate. But Ms. Rivlin advised the lawmakers not to expect Mr. Clinton to use the veto much, or to achieve great savings with it.

"I'd think it would be a relatively small proportion of discretionary spending that would be a candidate for the line-item veto," she said, adding that Mr. Clinton would wield it as a "targeted" weapon on spending he felt was particularly egregious, not as a broad brush to wipe out vast amounts of spending he dislikes.

Others said the bills being studied cede an extraordinary amount of legislative power to the White House with no guarantee, they said, that future Presidents would use it responsibly.

The legislation gives the President power not only to strike expenses listed in the text of Federal spending bills, but also to dip into individual spending accounts and eliminate projects that are not explictly listed in the bills themselves. Moreover, a President would be able to save his spending cuts from a hostile Congress — and avoid a vote on the House or Senate floor — if he could round up enough votes to bottle up a veto message in committee.

Robert Reischauer, the director of the Congressional Budget Office, testified that only 11 of the 43 states with line-item vetoes give that much power to their chief executives. And studies show that most governors use the veto not to hold down spending, but to enforce their own spending priorities over those of legislators, he said.

Norman Ornstein, the veteran analyst of Congress at the American Enterprise Institute, a Washington research organization, advised lawmakers drafting legislation to look to Presidents like Lyndon B. Johnson and Richard M. Nixon, who could use the Federal budgets as blunt instruments to bend others to their will.

"What you're dealing with, more than anything else here, is a transfer of power, not a case of spending restraint," Mr. Ornstein said. "Be careful about how much power you want to move."

Both the House and Senate committees plan votes on final versions of their bills later this month, and if they pass — as expected — the full House will take up the issue on Feb.

DIARY

Developments in Congress

HOUSE It is beginning to look as if a crucial element of the House Republicans' Contract With America — one that is intended to make it almost impossible for Congress to raise taxes — lacks enough Republican support to survive. Instead, a more moderate rival, conceived and nurtured in part by conservative Democrats, has the best chance of winning House approval, and perhaps the Senate's too, as part of the balanced budget amendment. When the House Judiciary Committee voted on Tuesday to approve such an amendment, the three-fifths requirement for tax increases was part of it. But in an interview yesterday, a senior Republican aide who spoke on condition of anonymity said that such a hurdle to future tax increases "ain't gonna fly."

SENATE The Senate began debate on legislation that would reshape relations between Federal and local governments, making it harder for Washington to impose rules on cities and states without helping pay the costs. But the opening debate took longer than the Republican majority had planned, as some Senators cautioned against hasty votes on something they do not yet fully understand, and indeed Democrats won some extra time to develop several amendments limiting the measure's scope. "There is still some confusion, frankly, among a lot of members as to exactly how it will work," said Senator William S. Cohen of Maine, a Republican.

WHITE HOUSE By definition, it was a small affair. President Clinton set up a Cabinet Room chat for the 13 new House Democrats, and 11 of them showed up. After the meeting, intended to rally support for the President's legislative program, the Democrats praised Mr. Clinton for reaching out to the middle class but most steered clear of endorsing specifics like his $60 billion tax-cut plan. Representative Mike Doyle of Pennsylvania said many were reserving judgment on specifics "until we hear more from him."

WSJ 1/13/95 p. A16

House GOP Won't Revise Plan to Deny Aid to Teenage Mothers, Legal Aliens

By HILARY STOUT
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – House Republicans outlined their welfare-reform bill, announcing they will stick with their original plan to deny teenage mothers and legal aliens aid under many federal antipoverty programs.

Earlier this week, Speaker Newt Gingrich indicated at a news conference that the GOP was rethinking some of the more contentious elements in its welfare bill, particularly a provision that barred legal aliens from receiving such assistance as food stamps, Medicaid, disability payments and cash assistance. But yesterday, House Ways and Means Committee Chairman Bill Archer made it clear the GOP now plans no such revisions: "Welfare for most non-Americans will be terminated."

"People should not expect to come to this country with their hands out to receive benefits paid for by taxpaying Americans," the Texas Republican said. The Ways and Means Committee plans to take up a welfare bill later this month.

The chief reason for the legal-alien measure appears to be money. Limiting welfare benefits to U.S. citizens will save about $22 billion over five years, Republican lawmakers say. "This provision is very important because of the revenue stream," said Rep. Clay Shaw (R., Fla.), who heads the Ways and Means subcommittee with jurisdiction over welfare legislation.

Mr. Archer and Mr. Shaw outlined the GOP's welfare bill for reporters and newspaper columnists. The legislation is being drafted following negotiations with a group of Republican governors. It is intended to supplant the welfare-reform proposal within the House Republicans' "Contract With America," but will retain many of the contract's elements.

Rocky Road in Senate

Much of the GOP leadership's bill has a good chance of clearing the House before spring, but the legislation will face a far tougher time in the Senate, where Republicans tend to have more moderate views on welfare. Meanwhile, the Clinton administration remains strongly opposed to many of the measures the Republicans are discussing. The president is planning a day-long work session with members of Congress and governors from both parties Jan. 28 in an attempt to find some common ground on welfare reform.

The House GOP bill will strip the nation's two chief welfare programs – food stamps and Aid to Families with Dependent Children, or AFDC, the government's main cash assistance program – of their entitlement status. That means the government no longer will be required to provide assistance for anyone who qualifies, but rather will allot a fixed pot of money each year for the programs.

The money for those two programs and for an array of others would be lumped into several "block grants" to be distributed to states to spend generally as they see fit. Three grants are all but certain: one for cash welfare, which includes AFDC; another for child care; and the third for child welfare, which includes foster care and adoption programs. Also under serious consideration is a nutrition block grant that would include the existing food-stamp and school-lunch programs. Mr. Shaw said he thought the legislation would divide more than 300 poverty programs into eight block grants.

Some Governors Resist

To receive the money, however, states would have to adhere to a set of federal guidelines that includes the legal-alien provision, the lawmakers said. That's something most Republican governors have been resisting.

In addition, federal government would insist that states:

–Adopt nothing longer than a two-year limit on the amount of time able people can receive AFDC benefits without working for them. (Exceptions could be made for parents of disabled children and others.) An overall five-year limit would be placed on AFDC participation.

–Deny federal AFDC benefits to any mother under 18 years old. "We're not trying to be cruel to anybody or punish anybody," Mr. Archer said. "But for some of these teenage moms, the cash was actually an inducement for them to get pregnant. It was their ticket to independence, their ticket out of the house."

–Deny AFDC benefits to mothers who don't cooperate in helping states establish the identity of their child's father.

–Deny additional AFDC benefits to mothers in the program who have additional children.

Amount Is Undecided

Still undecided is the level of funding for the block grants. The governors have said they will accept a five-year funding freeze for the various programs at the levels for fiscal 1995, which ends Sept. 30. But yesterday, Mr. Shaw said a freeze wouldn't be sufficient to reach the GOP goal of saving $40 billion over the first five years of the welfare-overhaul plan.

While many members of both parties support the concept of giving states more flexibility through block grants, the specifics of the GOP plan are highly controversial. "Most of our forebearers were legal aliens," said Gov. Howard Dean, the Vermont Democrat who heads the National Governors Association. "I don't believe we ought to break the entitlement" on AFDC and food stamps, he said, contending that in a recession many needy children would be denied benefits.

In an effort to strike back at the Republican proposal, the administration released a Department of Health and Human Services analysis of the effect of an AFDC block grant on states.

If a block grant had been established in fiscal 1987 and funded at 103% of that year's spending levels, by 1993 every state would have lost money, according to the analysis. Federal AFDC payments to California would have fallen more than $1 billion, or 33%, for example, and dropped $12 million, or 61%, for New Hampshire.

HHS Secretary Is Questioned

As Republicans were mapping welfare reform, Health and Human Services Secretary Donna Shalala fielded questions about potential cuts from this year's social-service budget in an appearance before the House Appropriations Committee. The new Republican leadership has vowed to rescind billions from prior appropriations. But as the executive branch obligates money, there is less for the GOP to save in the remaining eight months of the fiscal year.

For example, the fuel-assistance program for low-income people is almost certainly a target. Ms. Shalala indicated that all but about $300 million of a $1.4 billion appropriation had already been obligated. Cutting the remainder could impose a hardship on some states, such as Texas, which typically receive their share later than others. And Rep. John Porter (R., Ill.), chairman of the subcommittee overseeing the program, was reduced to talking about cutting advance appropriations for next year – something that will produce little short-term savings.

While reluctant to discuss the president's forthcoming budget, Secretary Shalala vowed that the administration will "eliminate unnecessary government programs and . . . cut back others."

Consolidation of Functions

In several exchanges with members, she signaled a willingness to consider broad consolidation of functions in her department. "You'll see even stronger recommendations over the next year," she said.

Also on Capitol Hill yesterday, the administration reiterated its support for a line-item veto, and then went a step further.

White House Budget Director Alice Rivlin told the Senate Government Affairs Committee that the president favored "the strongest version" of a line-item veto. Several versions of the bill have been proposed in recent weeks; the toughest would allow the president to kill not only individual items in spending bills but also some special-interest tax breaks.

–David Rogers contributed to this article.

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War Over an Overhaul Appears to Be No Contest

Advocates for Poor Are Set for Uphill Fight

By ROBIN TONER

Special to The New York Times

WASHINGTON, Jan. 12 — Scarcely believing how much ground they have lost in the past six months, advocates for welfare recipients are beginning to regroup for what is widely expected to be an uphill battle against an array of Republican proposals to fundamentally restructure poverty programs.

They face these immense hurdles: A public clearly fed up with the ineffectiveness of existing welfare programs; a Democratic Party on Capitol Hill still reeling from its losses in November, and an Administration eager to identify itself with "welfare reform" that has at times seemed reluctant to challenge major elements of the Republican plans. "The silence of the White House is startling," the Rev. Jesse Jackson said in an interview this week.

Moreover, some of these advocates and their allies say, they cannot hope to engage in a war for public opinion even remotely like the one waged in the last great struggle over social policy — health care. "Low-income people don't send generous checks to advocacy groups to represent their interests," said Jennifer Vasiloff, executive director of the Coalition on Human Needs, an alliance of about 100 social welfare, charitable and religious groups that was originally created in 1981 to try to counter the Reagan budget cuts.

"You have a lot of organizations that operate on a shoestring trying to get information out," she said. "This is not the health care debate, where you have monied interests with a great stake in the outcome."

For all of that, the advocates and their allies have begun generating news conferences, reports and news releases, trying to change the terms of the debate, which will escalate when hearings begin on Friday in the Ways and Means Subcommittee on Human Resources. That panel is expected to begin writing and voting on actual welfare legislation next month, and the full House is committed to voting on a welfare overhaul as part of the Republicans' agenda for the first 100 days.

As the process lurches on, the advocacy groups hope to shift the attention of a frustrated public away from the mothers on public assistance and toward the children who, these groups argue, would be the ones truly punished by many of the proposals now being advanced. Among those proposals are automatic time limits for welfare, the denial of benefits for the children of unwed teen-age mothers and capping the spending growth of several major welfare programs.

"When the American people voted for change, and for less government, I don't believe they voted to hurt millions of children, or to make them hungrier or homeless, or to take them away from their families," said Marian Wright Edelman, president of the Children's Defense Fund, at a news conference this week.

Representative Charles B. Rangel, a Manhattan Democrat who is a member of the Human Resources Subcommittee, said, "While we're doing this political thing, whether it's Clinton or Gingrich or Clay Shaw, the bottom line is we're talking about children not being cared for." Mr. Shaw, a Florida Republican, is the chairman of the subcommittee.

"I just cannot believe that as frustrated as the American people are, knowing that the system is breaking down, knowing that it creates a dependency, I just really don't believe that these are solutions they can live with," Mr. Rangel said.

Critics like Mr. Rangel clearly hope to capitalize on the public ambivalence identified in a survey made public today by the Kaiser Family Foundation and Harvard University. It found that two-thirds of Americans supported a time limit on welfare benefits, but only 16 percent would favor it if the beneficiary could not find a job.

Another major part of the liberal critique is targeted at governors. Advocates for welfare recipients hope to persuade the governors that the Republican proposal to replace many of the existing poverty programs with lump sum payments to the states, known as block grants, might sound attractive, but is in reality a fiscal time bomb. No longer would Federal aid to the states automatically expand as the caseload expands, they say, which is the case with the current "entitlement" programs.

"The first reaction of state officials is sometimes an interest in having more flexibility and the belief that with fewer Federal requirements they could do a better job," said Mark Greenberg, who is with the Center on Law and Social Policy, a public interest legal group in Washington that specializes in antipoverty policy. "However, no block grant formula is able to predict a recession — or to predict accurately the number of people who will need help a year or two or three years in the future."

Gov. Howard Dean of Vermont, a Democrat who is the chairman of the National Governors Association, said that in such a situation, "states are faced with a choice of raising taxes dramatically in a recession, which in this environment is unlikely, or cutting people off, which is basically children." Mr. Dean asserts that in his conversations in recent days, he found considerable uneasiness among Republican governors about this element of their party's plan.

A spokesman for the Ways and Means Committee said the panel's chairman, Bill Archer, Republican of Texas, wanted to explore ways of adjusting for regional differences in times of recession. More broadly, the spokesman said: "Nothing is crueler to our children today than the present welfare status quo. It's not working and it has to be changed."

In fact, a central political reality in the coming struggle is that nobody wants to defend the status quo. Representative John Lewis, a Georgia Democrat who is a longtime advocate for the poor, said: "I think we all believe there must be changes. I think we have to continue to say that we're a caring and compassionate nation, but our compassion and sense of caring doesn't mean that we do something that's inefficient, or something that's not working."

But many liberals seem downright stunned by how fast the debate over welfare has moved to the right, a development that gained even more momentum with the Republican victories in the November elections. "Two years ago, I thought my biggest fight would be against Clinton's proposals," Mr. Rangel said.

So far, many analysts say, there has been no downside for a politician to broadly embrace the idea of "welfare reform." But the same was once true of the health care overhaul, and that ultimately derailed on the details. Sharon Daly, deputy director of Catholic Charities USA, said she had been urging the organization's agencies around the country to meet with their representatives in Congress and to explain those details.

The Child Welfare League, a 75-year-old association of 800 such agencies, is adopting a similar strategy. "We're going to fight like hell," said David Liederman, executive director of the league. "Why go through this exercise to create more poor kids, more orphans, to put more and more children below the poverty line?"

Dear Anwar, Geneva, 3/3/93

Things are going very well. I'm too busy for my own good, but enjoying it. We've just found a house, we move in later this month.

All my best, Thor P.S. hope you enjoy this article.

Perspectives of US Economic Policy under the New Government

LESTER C. THUROW

If you look at the world economy at the moment the way President Bill Clinton in the United States must be looking at it, what you see is the confluence of three events.

The first event is in the 1980's: the world economy is characterized by a speculative bubble (similar to the South Sea Bubble in the 1920's). People were willing to buy at any price and accumulate debt. Later, people will ask themselves, how could any sane human being have done that. We even know what the ultimate bubble of the 1980's will be: Canary Wharf on the Isle of Dogs in London. A complex of buildings that cost US$ 7 billion and is currently estimated to have a market value of US$ 400 million. Those kind of projects were duplicated around the world.

But speculative bubbles always end in a financial crash, and it is important to understand that we have had a financial crash. Every bank in America and Scandinavia has gone broke. Their doors may still be open but they have all lost all of their equity.

In the last two years the Japanese stock market has gone down (in real terms) more than the American stock market went down from 1929 to 1932. The value of commercial property or residential property is down 40 percent.

What you are seeing at the moment is not a recession. It is a period of cleaning up the mess at the end of a speculative bubble following a financial crash.

This is, of course, why Great Britain's recession lasts longer than its great depression, not deeper but longer. It is also why, when President Bush did not get reelected in November 1992, there were fewer employees on American payrolls than there had been four years earlier. This is the first time this is happening in America since the 1930's.

After you emerge from a boom, a crash and a later period of cleaning up the mess you have a very different economy. In the United States, every bank has gone broke, three quarters of the airlines have gone broke, 15,000 retailers including many of America's biggest have gone broke, the average city has eight years of office space if we don't build another building and, as I have already mentioned, residential housing prices are down 40 percent.

When we come out of this we are going to have a different banking system, a different airline system, a different retailing system, a different real estate system and family finance is going to be very different because Americans got used to the idea that the smartest thing you could do was to buy a house bigger than you could afford and live on the capital gains.

The second trend impacting Mr. Clinton is even more serious. Suppose I look at the growth rates of the capitalist world economy decade by decade over the last four decades.

In the 1960's the capitalist world economy in real terms grew 4.9 percent per year. In the 1970's that fell to 3.8 percent. Everybody said that that was due to the oil shocks, the inflation caused by the oil shocks and the need for governors to brake their economies to stop inflation. When the oil shocks would be over and the governments could take their feet off the brakes economic growth was expected to speed up.

In the 1980's the oil shocks went away. How fast did the capitalist world economy grow? 2.7 percent – down more than another percentage point!

How fast has the economy grown in the 1990's? Less than one percent! And in 1991 for the first time since World War II the world GNP did not grow.

Some countries went up, some countries went down, but the world GNP remained stable. You can see this very persistent 33-year trend towards slower rates of growth in the world economy.

Suppose you take any product you can name all around the world and add it up to the production capacity. Estimate how much the world will buy of that product – and you will find at least 30 percent excess capacity! For many products the world can build twice as much as it will buy. That is true of automobiles, computers and a whole host of other products.

The third event that is hitting the world economy is the fact that the Pacific Rim achieves a 200 billion dollar trading surplus that never goes away and only gets bigger.

At American productivity levels US$ 40 billion equal a million jobs. At Austrian productivity levels US$ 40 billion equal more than a million jobs. So the Pacific Rim is effectively exporting 5 million unemployed people to either the United States or Europe. If you look at the pattern of those surpluses and deficits, about 3 million of those unemployed people are in the United States and about 2 million in Europe.

The question is, how do you get your economy moving if you have to carry the burden of 5 million unemployed people being exported from the Pacific Rim? And in addition you have to carry a 200 billion dollar trade deficit that comes out of the Pacific Rim!

If you look at these three factors and ask what is Mr. Clinton planning to do about them, of course one answer is that we don't know it for sure. Or you can start to guess – based on what he has said and what the options open to him are.

Mr. Clinton desperately needs to make the US economy grow faster (despite the fact that, if you look at the

three big economies in the world – Japan, Germany and the United States – America is already growing the fastest of those three) because in the United States if we don't grow at least 2.5 percent per year unemployment goes up. America would need at least a 4 percent growth rate for the next few years to get unemployment rates down and to do what Mr. Clinton promises to do.

The question is: how do you accelerate the American economy so that it will grow at about 4 percent per year?

It would not do any good to cut personal taxes because this would induce the individual American family to simply repay its debts. It would not do any good to cut business taxes. Business firms don't need to invest. They would simply repay debt and one would not get any stimulus.

One certainly does not want to increase public spending like pensions because if one pushes them up one will never get them down. What is left to Mr. Clinton is to focus on infrastructure investments (roads, ports, airlines, telecommunication systems, training schemes) because this is what the United States needs most.

In the last 15 years the US has cut infrastructure investments by fifty percent. One big advantage of infrastructure investment is that it does not require imports. This is very important, because if you were to give individuals money and all they do is buy goods from the Pacific Rim, Mr. Clinton would be creating jobs in Taiwan but not in the United States.

Another significant advantage of infrastructure investments is the easy way you can control it. The government can first increase and then cut them, you build a bridge and when it is built you don't build a second bridge. Therefore it is the easiest thing in government budgets to cut. This is of course the reason why it has been cut in the last 15 years.

So you will see Mr. Clinton designing an infrastructure stimulus package for the United States, the only question at the moment is how big the package will be.

Right before the election the American Department of Commerce announced that in the third quarter the American economy was growing at 2.7 percent per year. That is about twice its growth rate in the past. Nobody believed the number – everybody expected it to be revised downward – but after the election it was revised upward to 3.7 percent.

I remember the famous George Bernhard Shaw aphorism: "If you have the choice between a lucky man and a smart man, take the lucky man every time!". The fact of the matter is that Mr. Clinton needs to be a little bit lucky as well as smart. Being smart is not good enough. What you need is good luck. Suppose, however, that Mr. Clinton succeeds and makes the American economy grow at 4 percent per year while Europe and Japan are both not growing. What problem does he immediately confront? He immediately confronts the fact that imports would roll into the United States from both Europe and the Pacific Rim and they would basically drown the recovery.

Mr. Clinton has the problem that he cannot do for the world in 1993 what Mr. Reagan did for the world in 1982 and 1983. Mr. Reagan stimulated the American economy so that it was growing at 10 percent per year in real terms from 1982/83. Imports flooded in from both the Pacific Rim and Europe, and the OECD tells us that in both 1982 and 1983 85 percent of the growth in Europe could be traced to exports to the American market and 105 percent of the growth in Japan could be traced to exports to the American market because the Japanese domestic market was shrinking while the GNP was growing. The problem is that the United States is not big enough to do that anymore.

Mr. Clinton says he will focus on domestic economic policies. But one minute later he is going to focus on international policies because he is going to have to find some way to limit imports.

He cannot tolerate rapidly rising exports from Japan and the Pacific Rim if he wants to keep the American recovery going. The question is how is he going to do that. We know very clearly what will not work but we don't know what will work.

One of the things that did not work is asking the Japanese to open their home market. The world has asked the Japanese to do that for twenty years and they have been very good at ignoring it. And it has not happened. Because in a recession the only technique the Japanese know for avoiding a recession is exporting more. And that is exactly what we see at the moment. Japanese exports are rising very rapidly in the middle of their recession.

We know that lowering the value of the dollar will not work. If you look at the price of tradable goods, tradable goods prices in Tokyo today are 86 percent above those in New York City. And if you cannot solve the balance of payments problem with an 86 percent price differential, why should a 100 percent price differential work.

So if lowering the value of the currency does not work, and urging the Japanese to change does not work, the question is what will work? I think that this is one of the dilemmas facing the Clinton administration. It has to do something and the standard things to do don't work.

I suspect the answer is that the Clinton administration is moving towards managed trade where it tells the Japanese that there will be some relationship between what Japan sells and what Japan buys. And if Japan does not want to buy it will not be allowed to sell. Of course this would be a violation of the most favoured nation principle, it would be a violation of GATT, but Mr. Clinton will have no choice.

If you look at the slowdown in the world economy you have to ask yourself whether anything is happening to reverse it in the 1990's. We know that it could be reversed. What you need to do is to coordinate German, Japanese and American macroeconomic policies, and if you can do that you can make the world grow quite rapidly.

Why do I say that so confidently? We had an experiment not too long ago and it worked. You remember the stock market crash of October 1987? Before that crash happened, 1988 was expected to be a rather

poor year in terms of world performance. After the crash it was expected to be a really lousy year. In the event 1988 turned out to be the best year for the world economy in the entire decade! The reason of course was that in the aftermath of the crash the big countries all lowered interest rates, cut taxes, raised government spending, had a little bit of fiscal stimulus and with the big economies all moving in the same direction the world growth rate picked up almost instantly.

The problem is that in the 1990's – without the stimulus of a financial crash in every country at the same time – there is no way to put that coordinated macroeconomic policy together.

The Germans won't lower interest rates, the Japanese won't lower their trade surplus and the Americans won't shift their policies so that they are net lender to the rest of the world rather than net borrower from the rest of the world.

Unless all three of those things are changed you can't go back to a five percent world growth rate, so the most likely scenario is one of sluggish growth for the rest of the decade. Maybe it will not be as bad as it is at the moment but why don't we try 1.5 percent on for size, down another percentage point from the 1980s?

The second set of events facing Mr. Clinton is that resulting from a combination of technology in the world economy. The technological changes are very simple. Traditionally there were four ways where countries could compete. You could have more natural resources than your competitor, you could have more capital than your competitor, you could have better technology than your competitor or you could have a better skilled or educated workforce than your competitor. You can put some combination of those four together and you could be a winner.

The problem here that Mr. Clinton faces – and this is why he focuses on skills – is that three of those variables have essentially dropped out of the equation.

Think about natural resources. A combination of the green revolution and the material science revolution has made them irrelevant. Raw material prices in 1990 after correction for inflation are 30 percent their 1980 level. In 1980 they were 10 percent lower than in 1970. A 40 percent decline in two decades. Who has the world's best steel industry? Japan! Who has no iron ore and no coal? Japan. Because you don't need iron ore and coal to have the world's best steel industry in the 21st century even though you needed them in the 19th century.

The second thing that used to give countries like Austria and the United States an advantage is that you could have more capital than the underdeveloped world, essentially work with more machinery per person. But today I, a Bangkok entrepreneur, can build a facility in Bangkok that is just as capital-intensive as any you can build in Vienna or I can build in Boston despite the fact that you live in a country where the per capita income is 22 times as large as mine because we all borrow at the same places (New York, London and Tokyo) and if I can't build that capital-intensive facility in Bangkok one of your companies will borrow the money in New York, London and Tokyo and build that facility in Bangkok and there is no way you can beat me simply because you live in a rich country and I live in a poor country.

The third thing you used to be able to do is getting a little edge in technology. But this runs into the phenomenon of reverse engineering. Think about the three biggest products introduced into the world economy in the last two decades: video camera and video recorder invented by the Americans, fax invented by the Americans, CD-player invented by the Dutch.

Who owns all three of those products when it comes to billions of dollars in sales, hundreds of millions of dollars in profits and hundreds of thousands of high-wage jobs? The Japanese, who did not invent any of them! Because if I can make the product cheaper than you can make it, I can take it away from you even though you invented it. And the fact that you invented it is going to do you remarkably little good.

If you think of those four strategic factors what are you left with? The skills of the workforce; there is nothing else out there that can give you, in the long run, a sustainable competitive advantage.

That is why Mr. Clinton has focused sharply on talking about skills and education. Furthermore, in the era after World War II we did not, in some sense, live in a competitive world economy. Think of the three big economies in the world (Germany, Japan and the United States) in 1950. The United States had a per capita income four times that of Germany and 15 times that of Japan.

So suppose I go to those economies in terms of their industrial policies and I say what industries would you like to be successful in the next decade to give your citizens a rising standard of living? The Japanese tell me about a set of high-wage industries in Japan that they would like to conquer, but what looks high-wage from the Japanese point of view is low-wage from the German point of view, and so as the Japanese expand they are not taking away the jobs the Germans want.

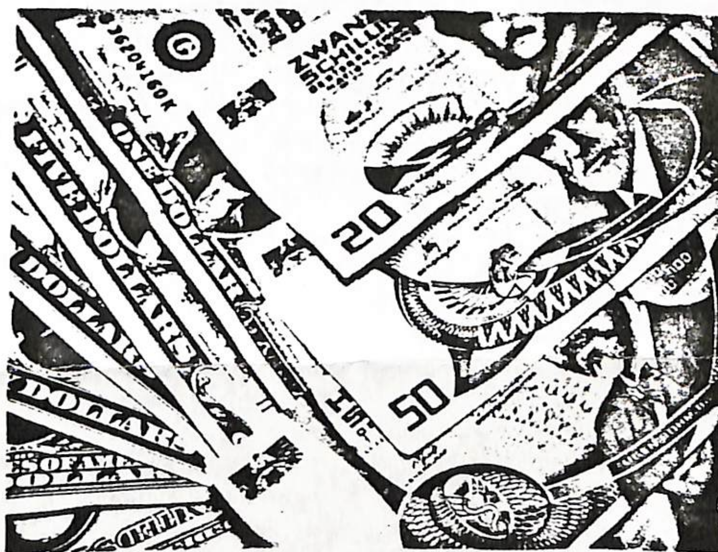
Similarly what is high-wage in German terms is low-wage in American terms, so when the Germans expand into the industries that they want, that does not bother the Americans. The Americans tell me about moon-shots, high tech, high capital-intensive industries that nobody else can do or afford to do, so when those industries expand in the United States they are not stepping on anybody's toes either. But it is now 1992 and if you look at these three big economies – the western part of Germany, Japan and the United States – they have roughly equal per capita GNP, roughly equal abilities to mobilise capital and roughly equal technology.

Suppose today I go to them and ask for their list of industries when they have these roughly equal positions. Once a decade the Japanese publish their list – the most recent list was published by MITI in 1990 called "The Visions for the

90's". In that document the Japanese said "we want industries that have a high value added, that can pay high wages and high profits, or are expected to have a high rate of growth in productivity so that wages can go up rapidly, or are expected to have a high income elasticity of demand so that markets will expand rapidly and have complementarities". By that they simply mean that if you conquer one industry it will allow you to conquer another industry. That of course is why new materials are important. If you think of the automobile made out of iron and steel it is a very old mature technology and there are not going to be any breakthroughs. But if you can make the ceramic engine and the other guy cannot, you can drive anybody else out of the automobile business which is the world's largest.

So after looking at these four characteristics the Japanese came to the conclusion that there were seven industries which they would like to dominate in the 1990's and in the early 21st century. I would like to give you the Japanese list: microelectronics, biotechnology, new material science industries, telecommunications, sea and aviation manufacturing, robots and machine tools, computers plus software. Do these industries appeal to anyone in Austria? If so, you will meet up against Japanese industrial policies.

A few months after getting this Japanese list I was put on the mailing list of the Economics Department from the Deutsche Bank in Germany, and I got a publication from the bank that said Germans must dominate the following seven industries. Guess what the seven were! Exactly the same seven! In the United States we don't make such a list but if we did, guess what would be on it. The same seven! This brings me once again to Mr. Clinton because in the United States in the last fifty years we have not had an economic strategy. We have, however, had a geopolitical military strategy that was very carefully designed. The group for working out the strategy was called "National Security Council" and the prime person responsible for the strategy's coordination was the "National Security Advisor".



Mr. Clinton wishes to establish an Economic Security Council in the United States and has appointed an Economic Security Advisor whose job will be to coordinate an American economic strategy for basically conquering those seven industries or something like them.

One of the things that he is going to do, and which is already being done everywhere around the world, is to lock up technology and make it much more expensive and much harder to access, so this whole question about how you get access to technology is going to become a very different problem in the next half century than it was in the last half century.

In the United States the vice president does not have anything to do. His only job is to break ties in the United States senate and this case almost never occurs. If you ask what the constitution says about the vice president, in the next four years he will have about two minutes worth of work. Therefore one of the jobs of every president is to make a job for his vice president.

Mr. Clinton has announced that he will make vice president Gore his czar for technology policy. The United States always has had a military technology policy, but until now it has never had a civilian technology policy.

Thus part of this strategy is to develop this civilian technology policy. If you think of trying to stimulate the American economy and develop this American economic strategy, one of the things which you have to ask is what is the game that is going to be played.

The Clinton people will very soon realize that the GATT/Bretton Woods game is over and that there is a new game underway which I would like to describe as "quasi-trading blocs with managed trade". I call them quasi-trading blocs to distinguish them from the trading blocs of the 1930's which tried to prohibit trade. These trading blocs won't prohibit trade but they will manage trade.

So if you look at the multifibre textile agreement, the Japanese-American semi-conductor agreement, the European-Japanese automobile agreement, these are exceptions to the GATT free trade world, but this is how the world will be working in the 21st century.

You can already see it now: the North American Free Trade group would not exist if NAFTA did not exist. Austria would not be asking to join the common market if you did not think that there was some advantage of being in the common market. If there were a world of free trade there would not be any advantage of being in the common market.

The Pacific Rim would not be talking about a trading group if the European common market and NAFTA did not exist.

One of the agendas on Mr. Clinton's table left by President Bush is what does he do about Mexico? Because President Bush negotiated a treaty with Mexico that nobody knows how to implement because he promised to integrate a very large poor country (Mexico)

with 90 million people and a per capita income of 2000 dollars in a very large rich country (United States) with 250 million people and a per capita income of 26000 dollars (13 times as much).

The gap between Mexico and the US is much bigger than the gap between Germany and Portugal, and Mexico is of course much larger relative to the US than Portugal is relative to the rest of Europe. Nobody has a clue how you integrate two such big economies with such different income levels.

On the other hand it is virtually impossible for President Clinton to repudiate the agreement because how do you tell a very big neighbor that the previous president lied to them. He signed an agreement that you don't intend to carry out. The basic answer is you can't.

At this point I would argue that you in Europe are going to have the same problem: why did Mr. Bush negotiate an agreement with Mexico? The idea was to make Mexico more prosperous so that fewer Mexicans would walk from Mexico to the United States.

I also know what the European Mexico is. It is called North Africa. I will bet you that within the next decade, one way or another, the common market will have to reach some kind of a free trade agreement with Africa for the same reason. If it doesn't, all the North Africans will be in Rome and Madrid.

The next problem bothering Mr. Clinton is something that will also bother Europe. As everybody says, it is that we are all going to be capitalists in the 21st century. That is true, but the problem is that the word "capitalist" covers some very different ways of doing things.

Let us imagine that we have an American farmer who practises capitalism as we do in the United States. What is that farmer supposed to do? He is supposed to very carefully buy his tractor, his car, his cow so that he is a profit maximiser and is able to have the biggest car, the biggest house and the longest vacation.

And we say you are successful if you have the biggest income, the biggest car, the biggest house, the longest vacation.

Suppose we have another farmer, a Japanese farmer, who says "Well, I will spend three hours on my tractor for every hour in my car. So, I don't really care about the car, I want the world's best tractor because I will spend many more hours on my tractor than I will in my Rolls Royce." Then he says, "Well, when it comes to my house all I do is sleep at night. Therefore, I don't care about my house. I want the world's best barn because I spend many more hours in my barn than in my house. And I don't really care about the Carribean vacation. I want the world's grand champion cow, the cow that gives the most milk in the world." Now, what happens if those two farmers compete? Of course, the farmer practising producer economics beats the farmer practising consumer economics. Both are capitalists but I would argue that was essentially the difference between the Pacific Rim and either Europe or the United States.

How are you going to get a six-week vacation if the guy whom you are competing against takes seven days? The answer of course is: you are not. If he has a better tractor, a better barn and a better cow, you will lose.

If you compare Japan and the United States, that is what you see in terms of the standard of living. If you ask who has the biggest house, the most cars and the longest vacations, Americans have a higher standard of living than the Japanese.

If you say, who has the most robots, the most civilian research and development, the most plant and equipment, Japan has a higher standard of living. You can measure the standard of living in two ways. You can measure it either according to producer criteria or consumer criteria.

This is one of the reasons why Mr. Clinton says that one of his big goals is shifting America from a high consumption and relatively low investment society to a much higher investment and lower consumption society.

While the problem he has got in America may be a little bigger than the problem that exists in Europe, there is no country in Europe that invests anywhere close to what any of the countries on the Pacific Rim invest.

This means that in order to invest a comparable amount, any country in Europe would have to be willing to cut its consumption substantially. Thus the problem may be different in size but it is not essentially different in degree.

The final problem Mr. Clinton is going to face is that we are going to live in what I call a competitive cooperative world economy where you are both going to have to compete and cooperate simultaneously. He wants your job but you have to work with him to make the system work. That is not an easy thing to do because if you say why didn't we cooperate in the last fifty years at least 60 percent of the reason is that everybody was scared of the Soviet Union as a military power. But the Soviet bear has gone away.

Germany does not need the United States to defend it, and Japan does not need the United States to defend it. The United States does not need an unsinkable aircraft carrier in the Pacific Rim. The United States doesn't care what happens to Bosnia because it is not part of a global communism versus capitalism cold war environment. The question is, in that kind of environment, how do you get the necessary cooperation done when there are no external forces that force you to cooperate. And on that one I think probably nobody including Mr. Clinton has a clue how you do it at the moment.

Lester Thurow is professor for management and economics at the Massachusetts Institute of Technology (MIT) and Dean at the Sloan School of Management. He is vice president of the American Economics Association. He was member of the US Presidents's Council of Economic Advisers (1964/65) and has published several books. (His main topics are income distribution, skill development and productivity.) This article is based on a speech given by Mr. Thurow at Bank Austria in Vienna.

THURSDAY, MARCH 9, 1995

Ties to Mexico Are Becoming Burden for U.S.

Neighbor's Economic Mess Damps Earlier Promise Of Regional Integration

By TIM CARRINGTON
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON—Regional integration, viewed as the big economic opportunity of the early 1990s, is emerging as the big economic headache of the late 1990s.

The U.S. links to Mexico, nurtured through increased trade and investment, were locked in by the 1993 North America Free Trade Agreement and capped off with last month's $20 billion U.S. rescue package. The upshot: the U.S. finds itself underwriting the troubled Mexican economy. And currency traders and politicians are worried that the U.S. is partner to a quagmire.

> **Pessimism Persists**
>
> **The peso fell to another record low amid signs that business leaders are opposing harsh new austerity measures being drafted by the Mexican government. Page A15.**

"We're responsible for the Mexican economy," says Clyde Prestowitz, president of the Economic Strategy Institute. Undersecretary of Commerce Jeffrey Garten goes even further. "We are married to Mexico with no chance of a divorce," he says, adding that he's optimistic that Mexico will soon recover from the financial maelstrom that began with the December devaluation of the peso.

A Financial Vietnam?

The U.S. commitment to Mexico, which some worry could turn into a financial Vietnam, is one of many factors contributing to the recent plunge of the dollar. Citing the dollar's slide, Sen. Alfonse D'Amato declared that "Congress must closely examine the administration raid on [the Treasury's] exchange-stabilization fund to bail out Mexico." The Senate Banking Committee, which the New York Republican heads, will hold hearings today on the rescue.

According to Ravi Bulchandani, an economist at Morgan Stanley & Co., "there's concern that Mexico compromises the ability of the Fed to conduct monetary policy." He thinks the worries are overstated. Testifying in the House yesterday, Federal Reserve Chairman Alan Greenspan sought to allay worries that the Mexico-rescue program impairs the U.S. ability to support the dollar. Said Mr. Greenspan: "In the event that the dollar resources currently in the exchange-stabilization fund become inadequate to meet our commitments to Mexico, we at the Federal Reserve will effectively swap dollars with the exchange-stabilization fund for their yen and Deutschemark – in a sense, warehouse them temporarily, and hence have them available as needed, in the event that intervention is required."

And although the $20 billion in loans to Mexico constitute a lot of money, it isn't a huge budget item for a government that plans to spend $1.5 trillion in the current fiscal year.

Grist for Isolationists

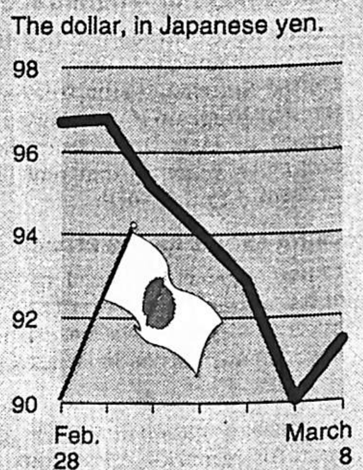
Mexico's continuing problems will provide grist for U.S. isolationists, with columnist Pat Buchanan maintaining that the dollar's drop points up the need to undo the trade and financial agreements that have linked the U.S. to its southern neighbor.

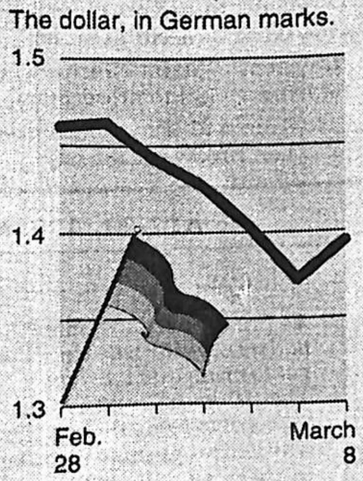
However, few outside the isolationist camp see any way to turn back the clock, or any wisdom in trying to do so. Cut off from U.S. financial support and trade, Mexico would likely become the source of more illegal drugs and more desperate immigrants. To a great extent geography is destiny. "There's no alternative to us playing a large role," says Mr. Prestowitz.

Allan Meltzer, economist with the American Enterprise Institute and Carnegie-Mellon University, views the U.S. rescue plan as "stupid and foolish," but he doesn't blame Mexico for the dollar's problem. He points to Japan's earthquake bills, and the resulting falloff in Japanese dollar investments. Compared to this, and structural problems like the U.S. budget and trade deficits, the Mexico rescue "is no more than a pin prick on top of a big problem."

Jorge Mariscal, a Latin America specialist with Goldman, Sachs & Co., argues that the dollar is depressed not so much because of the costly rescue itself, but the worsening Latin American recession, which is extending beyond Mexico to sweep in Argentina and Brazil, thereby weakening growth prospects for the U.S.

Dollar's Four-Day Plunge Halts; Greenspan Hints at Higher Rates





Source: Datastream

The New York Times

Action Is Suggested if a Weaker Currency Causes Inflation

By KEITH BRADSHER

WASHINGTON, March 8 — The dollar's four-day plunge in international currency markets halted today after Alan Greenspan, the chairman of the Federal Reserve, hinted that he might raise American interest rates, which would tend to encourage people to buy dollars.

Mr. Greenspan did not say the Fed would raise interest rates simply to defend the dollar. But he suggested that if the dollar's decline added to inflation here through higher prices for imports the Fed might respond by raising borrowing costs, slowing the economy and braking inflation.

At the same time, a senior German central banker said that rates might fall there, which could help strengthen the dollar.

In response, traders bought dollars and sold marks and yen. After falling to new lows in Tokyo trading, the dollar recovered in New York trading to 91.42 yen, from 90.05 on Tuesday, and to 1.3960 marks from 1.3705. Higher rates in the United States would make it more attractive for foreigners to invest in dollars, while lower rates in Germany would help reduce the flow of money into German marks.

In testimony to the House Budget Committee, Mr. Greenspan described the dollar's fall as "unwelcome and troublesome," as well as excessive, and said that the Fed would not let inflation be driven up by a weak currency.

"Dollar weakness, while very likely overdone, is unwelcome because it adds to potential inflation pressures in our economy," Mr. Greenspan said in his opening remarks today. "As I have emphasized numerous times in the past, it is important that we contain such pressures."

While Mr. Greenspan was indicating a willingness to raise rates, Hans-Jürgen Krupp, a member of the German Bundesbank's policy council, was addressing the other end of the equation that was pulling

Continued on Page D8, Column 1

NYT 3/9/95 pA1 + D8

THE RECOVERY

Dollar's Plunge Hal Greenspan Hints Action

Continued From Page A1

money away from the dollar. He said today that an interest rate cut was possible in Germany to stimulate the economy there.

"A rate reduction is possible because the economic upturn is still not so strong," he was quoted this morning as telling the business magazine Wirtschafts Woche.

Hans Tietmeyer, the president of the Bundesbank, added his support later in the day by saying that he expected the dollar to recover in value. The comments by the German central bankers and Mr. Greenspan, coupled with interest rate increases in France, Denmark and Belgium, appeared to have been coordinated.

Apparently waiting to see if Mr. Greenspan's comments would be enough to halt the dollar's slide, the Clinton Administration remained silent again today and took no action to intervene in currency markets.

Whether the Federal Reserve is actually prepared to raise rates or whether Mr. Greenspan is simply trying to bluff the international currency markets is unclear. The nation's central bank has a history of resisting pressures from currency traders and of setting interest rates

The Fed will fight inflation linked to a weak currency.

mainly in response to the domestic economy. During the last international currency crisis in July, the Federal Reserve actually chose to forgo an interest-rate increase at a meeting of its top officials even though the same officials had voted to raise rates during their three previous meetings in February, March and May.

It is not clear whether the rebound in the dollar was a response to Mr. Greenspan's remark or mostly a natural bounce after the dollar had fallen so sharply. But in the absence of almost any response from the Clinton Administration this week, Mr. Greenspan helped fill a void by signaling that Government officials consider the dollar's fall serious enough that traders need to start worrying about an effort by central banks to intervene.

Some analysts have attributed the dollar's fall to Mr. Greenspan's own comments two weeks ago that the Federal Reserve might start lowering interest rates. Traders have said that they felt free to sell dollars with little perceived risk that the dollar would bounce back in value because of a sudden interest rate increase.

Mr. Greenspan conspicuously avoided any mention today of lowering rates, warning instead that while some signs of slowing were now visible in the American economy, "the jury remains out on whether that will be sufficient to contain inflation pressures."

He also backed away from his suggestion last month that big cuts in the Federal budget deficit might prompt financial market shifts that would push the Federal Reserve to lower interest rates.

Some currency traders and economists interpreted these comments not as a hint of higher rates but rather as an attempt to bring back a sense of uncertainty among traders about the direction of American interest rate policy. "This is all working to introduce a sense of risk," said Robert V. DiClemente, a senior economist at Salomon Brothers.

He added that given the United States' limited reliance on imports, the risk cited by Mr. Greenspan of extra inflation pressures was plausible but modest.

But few currency experts believed that the dollar's problems were entirely over. David F. DeRosa, the director of foreign exchange trading in the New York offices of the Swiss Bank Corporation, said that very little money actually changed hands as the dollar recovered today.

"I don't regard this as a real rally," he said. "In the bat of an eye, it can drop."

Mr. Greenspan linked the dollar's weakness to the Government deficits he has lobbied Congress hard to bring down. Providing some support for Republican efforts to blame Democrats for the dollar's problems, Mr. Greenspan said he thought the selloff had been touched off by the Senate defeat last Thursday of the balanced-budget amendment to the Constitution. While Mr. Greenspan did not support the amendment itself, he called on Congress to meet the measure's goal of balancing the Federal budget by 2002.

Most economists have contended that the dollar's troubles reflect not so much the United States' chronic budget and trade deficits but the strength of the mark and yen. Investors have been pouring money into Germany as other European currencies, notably the Italian lira and the Spanish peseta, have plunged in value because of budget squabbles in Italy and allegations of political corruption in Spain. Japanese companies have been converting their overseas profits into yen in preparation for the close of the Japanese financial year at the end of this month.

But however effective Mr. Greenspan words may have been today in propping up the dollar, the idea of using interest rates to support the currency contains many perils. A group of conservative private sector economists who follow the Fed's moves issued a statement on Monday warning that another interest rate increase now would run the risk of tipping the American economy into a recession. Administration officials have worried that such a recession might come during the 1996 election campaign, hurting President Clinton's re-election prospects.

Mr. Greenspan devoted most of his testimony today to pleas for Congress to balance the budget. If anything, he said, the Government should be running a surplus so as to add to the pool of savings in the United States that can be invested.

NYT 3/9/95 p. D1 + D8

Dollar's Fall: Crisis Without a Bite

Harm to Economy Has Been Negligible

By LOUIS UCHITELLE

What's so terrible about a falling dollar?

It has been declining in value for nearly a decade against the two strongest currencies, the German mark and the Japanese yen — doing so gradually most of the time, but with occasional plunges like the current one. And the damage to the economy has been negligible.

Economic Analysis

"The dollar fell by one-third between 1985 and 1987 and the result was a very prosperous period for the American economy, with only a modest increase in inflation," said Robert J. Gordon, a Northwestern University economist.

Imports — Japanese cars, Italian clothing, Far Eastern electronics devices — get lots of publicity, and they can become more expensive as the dollar weakens. But nearly 90 percent of what Americans purchase is made at home, and a dollar buys just as many of those goods and services as it did a month ago, before the plunge. Even the imports, which should cost more in dollars as the currency falters, have not been going up in price. That's mainly because many imports come from countries whose currencies are even weaker than the dollar. But it is also because many Japanese and German exporters are wary of raising prices in the hotly competitive American market.

Raising rates to help the currency could be risky.

Still, the fall in the dollar is unnerving. Many foreigners hold dollars acquired over the years and there is always the remote chance that they will try to dump them en masse, exchanging them for marks or yen and setting off a full-blown currency crisis. "In the frame of 1995, that possibility won't make much difference to the economy," said Peter L. Bernstein, a New York economic consultant. "But in the longer run, the feeling that the dollar can be raided like the Mexican peso is not very comforting, or ultimately good for the economy."

The immediate risk to the nation today is that the standard remedy for a weak dollar — higher interest rates — could do real damage to the economy. Although the nation is enjoying a combination of healthy economic growth and low inflation, signs of a slowdown are beginning to emerge. Raising interest rates may exacerbate an incipient slowdown by discouraging purchases on credit.

"If the Federal Reserve panics and raises rates to rescue the dollar, that would raise the odds of a recession," said John R. Williams, chief economist at the Bankers Trust Company. "That would be very inappropriate."

So why has the dollar fallen so sharply? Analysts cite a host of factors. Some blame the Mexican crisis. Others fault Alan Greenspan, chairman of the Federal Reserve, for seeming to suggest last month that the Fed might lower rates soon to stimulate a weakening economy. Others argue that many Japanese holders of Treasury securities are selling them and converting their dollars to yen, for use back home.

But behind all this are foreign-exchange traders, constantly in search of the greatest short-term return on their holdings. They command enough capital to make any currency fluctuate sharply, and in the last two weeks many have settled on a better bet than the dollar.

Their latest bet is that the German central bank, the Bundesbank, will raise interest rates to stave off inflation in the prospering German economy while the Federal Reserve remains reluctant to increase rates simply to prop up the dollar. That, in turn, will make German securities increasingly more attractive than American securities.

"It looks like we are setting up an environment where German rates could move higher and American rates could hold steady or actually

Continued on Page D8

The Falling U.S. Dollar: A Crisis Without a Bite

Continued From First Business Page

decline," said William Sullivan, director of money market research for Dean Witter. "That favors holding marks."

But the American economy is buffered from this process. More than most other nations, the United States has been immune to the decline of its own currency.

That's because when it comes to haircuts or cars or soaps or fees for real estate brokers or computer software or lawyers, eight out of nine purchases are for American-made goods and services. Other purchases are for products imported from countries like Mexico, Canada and China, where the dollar has gained ground against the local currencies or held its own.

The nation's persistent trade deficits have put a lot of dollars in foreign hands, of course, and that can worsen the dollar crisis. Since the nation does not export enough goods or services to pay for its imports, foreigners have to accept dollars in exchange for what they sell to Americans. These dollars are then invested in American securities, particularly Treasury notes and bonds. The great fear has been that as the dollar weakens investors around the world will sell their holdings and exchange the dollars they receive for marks and yen, thus further weakening the dollar.

But the deficit from America's overseas transactions represents less than 3 percent of the nation's $6 trillion plus in annual economic activity. And foreigners hold only 7 percent of the total value of Government debt. An additional 10 percent is held by foreign central banks, which are reluctant to sell dollars because their chief goal is to keep their own currencies from becoming too strong against the dollar and thus prevent exports from becoming too expensive for Americans.

"I am not sure the dollar is ridiculously low," said Paul Krugman, a Stanford University economist, "but I do think the yen and the mark are getting ridiculously high."

True, the experience of a spectacularly falling dollar could prompt nervous investors to dump stocks and bonds. There were signs of this in the sharp fall in the Dow Jones industrial average on Monday. But the Dow recovered some yesterday and so far both markets are behaving as if the plunge in the dollar is a temporary phenomenon.

The dollar, in fact, even rose a bit against the mark and the yen after Mr. Greenspan's Congressional testimony yesterday, in which he spoke bullishly about defending the dollar. The next test could come tomorrow, when the Labor Department announces the jobs data for February. A strong employment report could strengthen the dollar, by suggesting that the economy is not so weak after all. That would hold out to foreign-exchange traders the hope of another increase in interest rates to once again try to slow a potentially inflationary economy.

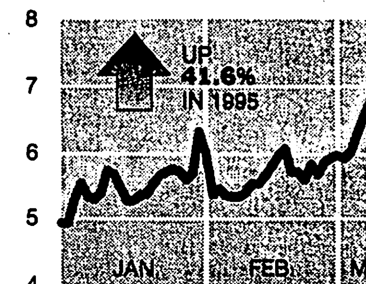
But a lot of currency trading is disconnected from real economic conditions and instead reflects a bet on what other traders will do. "The more the dollar fell, the more reasons were found to keep selling dollars and keep the fall going," said Edward Hyman, president of the ISI Group, a money management and trading firm.

That can turn quickly around as foreign-exchange traders, manipulating billions of dollars, decide that the dollar has fallen enough. Betting on a rebound tempts them.

"There has been panic selling of dollars but at some point there will be panic buying," Mr. Williams of Bankers Trust said. "Foreign-exchange traders don't try to analyze economies or call the shots. They just ride the momentum."

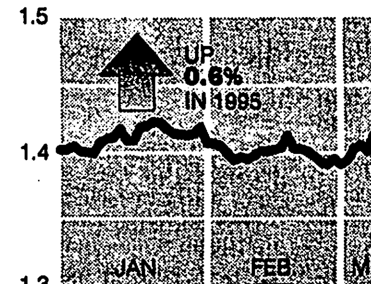
A Mixture of Strength . . .

MEXICAN PESOS to the dollar



% of '94 two-way U.S. trade: **8.6%**

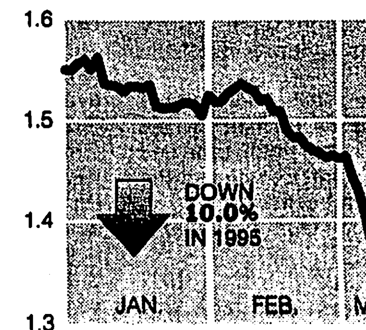
CANADIAN DOLLARS to the dollar



% of '94 two-way U.S. trade: **20.8%**

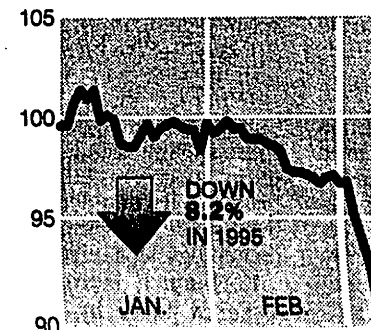
. . . and Weakness . . .

GERMAN MARKS to the dollar



% of '94 two-way U.S. trade: **4.4%**

JAPANESE YEN to the dollar



% of '94 two-way U.S. trade: **14.7%**

. . . That Moves Markets Worldwide

	Stock Index	Wednesday's close	Change in 1995	10-year Govt. bond yield	Change in 1995*
U.S.	The Dow	3,979.23	+ 3.8%	7.34%	–0.48
CANADA	TSE-300	4,136.00	– 1.8	8.66	–0.48
MEXICO	Bolsa	1,498.52	–36.9	n.a.	n.a.
GERMANY	DAX	2,025.21	– 3.9	7.43	–0.19
FRANCE	CAC-40	1,756.76	– 6.6	8.24	–0.03
BRITAIN	FTSE-100	2,992.10	– 2.4	8.71	0.00
JAPAN	Nikkei 225	16,621.31	–15.7	4.14	–0.43

*In basis points; 100 basis points = 1 percentage point.

Sources: Bloomberg Financial Markets; Datastream; Department of Commerce

The New York Times

Those damned dominoes

Systemic risk is the bugbear of central banks everywhere. How can governments deal with it?

ECONOMICS FOCUS

WHEN Barings, a venerable British investment bank, collapsed this week, financial pundits began worrying about the potential knock-on effects on other banks. Such fears of "systemic risk" invariably lead to calls for more and better regulation. But what exactly causes this type of risk, and what should governments do about it?

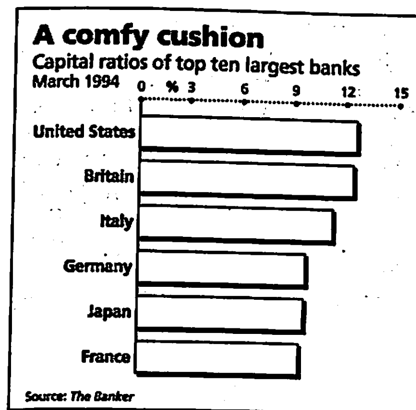
To most economists, systemic risk is the threat that the failure of one large financial institution will trigger a chain reaction. Consider, for example, a collapse of the payments system. Most large financial transactions are made electronically through some type of clearing house, usually run by a central bank. Since these transactions clear only with a lag, financial institutions face a risk that they will find themselves caught in the middle of a transaction with a bank that collapses, and not get paid.

If such a crisis causes people suddenly to avoid the payments system altogether, then this so-called "Herstatt risk" (named after a German bank which failed in 1974) can dry up liquidity, generating system-wide problems. This risk is especially high for international transactions, since the clearing houses of the central banks involved may not be open at the same times. By improving the system's capacity for real-time transactions, governments can greatly reduce one of the biggest threats to financial markets' soundness.

That still leaves another huge risk: runs on banks by nervous depositors. Suppose that a large, deposit-taking bank were to go bust. This could easily trigger a run by the customers of other, similar institutions. Since banks rarely maintain a large proportion of their assets in liquid form, a sudden surge of withdrawals could easily cause several other banks to fail as well, thus dramatically exaggerating the costs of the first bank's mistake.

One possible response to this threat is deposit insurance. Under such a scheme, banks contribute a small portion of their assets to a central insurance fund, typically run by the government. If a bank defaults, this fund guarantees the claims of depositors, thus insulating them from the threat of insolvency. By reassuring banks' customers that their cash is protected, deposit insurance aims to prevent them from panicking, thereby reducing systemic risk.

Most developed economies maintain some kind of deposit insurance. America instituted it in 1933, after a massive bank panic led to widespread insolvencies, greatly exacerbating its economic depression. This week, Greece became the latest country to join the list when it announced that it will set up a fund to insure deposits up to 20,000 ecus ($25,380) each.



The deposit-insurance remedy, however, gives rise to another problem: moral hazard. By insulating depositors from defaults, deposit insurance reduces their incentive to monitor banks closely. More important, it distorts the incentives of banks themselves. Because they are no longer liable for the deposits they have taken if they get in trouble, the potential cost to the banks' owners of risky loans and other investments is reduced. Banks can therefore take greater risks, safe in the knowledge that there is a state-financed safety net to catch them if they fall. As commercial banks expand into a broader range of activities, such as trading securities for their own account, the moral-hazard problem grows even bigger.

The desire to minimise the effects of their own insurance schemes drives governments to enact a number of additional regulations, all of which multiply the costs of reducing the original systemic risk. One of these is capital standards. These require banks to set aside a portion of their liabilities (often weighted according to governments' assessment of risk) in the form of safe assets—cash, government bonds and so forth.

The Basle accord, an international agreement among rich-country banking authorities, requires banks to hold core-capital reserves of 8%. Many national governments require even higher reserve ratios. These restrictions, along with shareholders' demands for greater soundness, have led big banks in most countries to hold even more capital than that required by the international minimum standards (see chart).

Besides requiring capital reserves, many countries also limit the types of assets banks can hold, and prohibit them from entering certain product lines—though the United States is planning to loosen one such restriction (see page 77). In addition, regulators tend to require ample disclosure of banks' financial information in the hope that this will deter risky behaviour.

Narrow-minded

In the case of bank runs, the potential threat to the financial system may be so great that such costs are warranted. Many economists, however, argue that there is an even cheaper way to eliminate this form of systemic risk. Their scheme, known as "narrow banking", would erect solid firewalls between the deposit-taking arms of banks' operations and the other activities in which they engage. For example, if a bank loses money on its commercial-lending acitivities, or through trading securities for its own account, depositors' funds would be strictly protected from these losses, even if the bank itself goes bust.

In return for this protection, narrow-bank depositors would have to accept slimmer returns on their savings, as banks would be permitted to invest these deposits only in low-return assets such as cash and Treasury bills. Supporters of narrow banking, however, say that these costs are likely to be far lower than the hidden costs associated with the status quo.

The narrow-banking cause is likely to get a boost from the public's current fear of derivatives. Futures and options, however, are not the real problem. If used sensibly, they can enhance the stability of the banking system; they could even help narrow banks to do a better job of managing, say, their interest-rate risk. But worries about derivatives are linked to the other problems that crop up as banks take greater risks for their own account.

Eventually, regulators will be forced to turn these activities over to the market. Narrow banking allows them to do so without leaving squeamish depositors exposed. The latter can turn to simple banks that invest only in the safest instruments: cash, government bonds... and, perhaps, a sprinkling of derivatives.

January 15, 1995

ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

FYI

The Myth of the Overworked American

by Kristin Roberts and Peter Rupert

Are U.S. workers toiling ever harder to maintain their standard of living and, if so, is it coming at the expense of leisure time? Survey data report that over the past decade, total hours of annual work have not changed by much, but the *composition* of labor has shifted from home work to market work. Nearly all of the difference can be attributed to changes in the total hours worked by women.

A perennial debate that has become even more sharply contested in recent months concerns the size and scope of government participation in markets. Free-market proponents believe that unfettered economic competition delivers the greatest prosperity level for the citizenry. Opponents challenge the record of private enterprise to improve the standard of living of individuals from all walks of life. A specific claim is that U.S. workers are increasingly being faced with the unpleasant option of either working ever harder—and enjoying life ever less—or consuming less and watching their material comforts diminish.

The presumption of declining leisure without compensating increases in the standard of living has served as a platform for proposed government-sponsored interventions into labor markets. Although the details and effectiveness of any given program can be debated, declining leisure opportunities, if true, quite likely spell a downward trend in the well-being of working men and women, and trouble for the proponents of a laissez-faire approach to economic policy.

The central message of this *Economic Commentary* is that the presumption of declining leisure is in fact a fallacy. Previous studies purporting to have uncovered such a fact have not adequately disentangled time spent in home production —activities such as meal preparation, laundry, home maintenance, or child care—from time spent enjoying leisure activities.[1] By carefully examining how nonmarket time is divided into home production and leisure, we document a trend that has far-reaching consequences for labor policy initiatives: Although the average worker is spending more time working for pay than in the past, this change has not come at the expense of leisure. It represents, instead, a shift from time spent in home production to time spent in market activities.

Such a change may come as little surprise. The proliferation of labor-saving home appliances and service-sector conveniences has dramatically affected most of our lives. As we argue here, it should also alter the way we think about the "overworked American" and any resulting policy prescriptions.

Our analysis finds that while hours of market work and home work have remained fairly constant for men since the mid-1970s, market hours have been rising and home production hours have been declining for women, as shown in figure 1. The latter trend also holds true for couples when both are employed in the market full time. Possible reasons include an increase in market versus nonmarket productivity or labor-saving technological advancements in the home. The substitution of one type of work for another in response to a change in relative productivities contributes to making the household better off.

■ Home Production Models

Despite important research in the area of household production in the mid-1960s and early 1970s, economists modeling individual behavior, especially in macroeconomics, have largely omitted hours of work in the home (that which produces consumption goods).[2] This omission apparently stems from a lack of data on hours of home labor, on capital goods in the home (microwaves, power tools, etc.), and on the output of such work. Some recent literature, however, has shown that models including a home production sector are better able to account for several aspects of aggregate economic time series and that there is some support for the substitution hypothesis.[3]

In other words, there are many ways to produce consumption goods using varying amounts of home and market time, and the amount of time spent in an activity is sensitive to changing economic conditions. Consider, for example, dinner. A family can "produce" dinner by combining capital equipment and time to produce the final product, a meal. But this can be done in many ways. We can combine our car with the time it takes to drive to a restaurant, order food, and eat. Or, we can combine our car with the time it takes to stop at the store, purchase frozen food, and then heat it in a microwave.

At the other extreme, we could combine a hoe, some dirt, and seeds to grow and then harvest our own food. Those who are "too busy" doing market work tend to minimize the time spent producing goods themselves by eating out, buying a microwave, or hiring cleaning and landscaping services.

Such home production models of household behavior can deliver vastly different results compared to models without home production, a fact that is relevant for policy analysis. Consider, for example, the effect of an increase in the labor tax rate on an individual who is working in the market and paying for child care. She may decide to decrease her market work (since each additional hour now earns less) and boost hours of home production. The more willing she is to substitute home- for market-produced consumption, the larger will be the change in her market hours. That is, higher taxes may lead her to work fewer market hours (or stop altogether) and provide her own child care.

The Data and Empirical Findings

To investigate the importance of properly controlling for home production, we arbitrarily sort households into two types: married couples with wives working in the market full time and those with wives out of the market labor force (neither working in the market nor looking for market work). We use the Michigan Panel Study of Income Dynamics (PSID) data set, which interviews individuals and families over time, to examine the mean number of weekly work hours from 1976 to 1988, the last year for which data are available (see table 1).[4]

In 1976, for example, in households where the wife is out of the market labor force, 44.6 total hours are spent in market work per week, while home work equals 38.4 hours, giving a total of 83 weekly work hours.[5] In families where both individuals work in the market full time (more than 35 hours per week), market work is 83.2 hours, home work falls to 26.2 hours, and total work is 109.4 hours.

TABLE 1 WORK HOURS OF HUSBANDS AND WIVES

	1976			1988		
	Total work	Market work	Home work	Total work	Market work	Home work
Married, wife is out of labor force	83.0	44.6	38.4	82.4	44.2	38.2
Husband	49.0	44.6	4.4	50.2	44.2	6.0
Wife	34.0	0.0	34.0	32.2	0.0	32.2
Married, both work full time	109.4	83.2	26.2	109.5	86.2	23.2
Husband	50.0	44.0	6.0	52.2	44.8	7.3
Wife	59.4	39.2	20.2	57.3	41.4	15.9

SOURCE: Authors' calculations from the Michigan Panel Study of Income Dynamics.

Obviously, this does not imply that when both members of a couple work, they neglect their home. As mentioned above, they may be able to substitute less time-intensive methods to produce the final good. For example, if a person's market wage rises, he may choose to stop working on his old car and either hire someone to do the repairs or buy a new vehicle. If we were observing only market work, we might mistakenly infer that his *total* hours of work rise and leisure then falls. However, once home production enters into the picture, this interpretation may no longer hold true. He could substitute two hours more of market work and reduce the time spent working on his old car by four hours, so that his total hours of work would actually fall.

Consider the differences in hours worked in 1988 versus 1976. In households where wives are out of the market labor force, we detect little change in weekly market hours in 1988 (down 0.4 hours) or in home hours (down 0.2 hours). In two-worker households, there is virtually no change in *total* weekly hours, but time has shifted from home to market work: Hours of market work increased by three per week from 1976 levels, while home labor fell by three hours per week. Figure 2 presents a year-by-year breakdown of total, market, and home work for various types of households. As mentioned above, for households with two full-time workers, there has been little change in the total amount of work. While market work has been increasing, home work has been declining at a nearly offsetting pace.

One explanation of this latter trend is an increase in the relative productivity of market- versus home-produced goods, leading to a change in the ratio of home to market hours. Other possible factors contributing to the substitution from home to market work are technological change in home production, including labor-saving innovations, more readily available child-care options, and the decline in family size over this period.

Table 1 also shows that in 1988, the total weekly work of a household where both persons are working full time, 109.5 hours, is much greater than that of a household where the wife is out of the labor force, 82.4 hours. Home work, on the other hand, is lower: 23.2 hours for two-worker households compared with 38.2 hours in single-earner households. That is, the reduction in home hours accounts for only about half of the gain in total hours between the two types of households. The remaining difference evidently comes out of leisure time.

This same pattern holds true for earlier years, but total hours of home work do not decline as much, perhaps reflecting the better substitution possibilities in 1988 compared to 1976, such as higher wages or labor-saving home appliances. These results highlight the fact that there is substitution between market and home work, but it is not one-for-one.

Interestingly, men do not appear to change *their* behavior much in response to a change in their spouse's market labor force status, as shown in figure 3.[6] Men work roughly 50 hours per week for both types of households. Table 1 shows that in 1976, for households where wives are out of the labor force, men work 4.4

hours per week in the home and 44.6 hours in the market, while women work 34 hours per week in the home. Total work in such households is 49 hours for men and 34 hours for women. Turning to two-worker households, in 1976 men work in the home about 6 hours, while women who work full time in the market spend 20.2 hours per week working in the home. However, men's total work stays roughly the same (increasing about one hour per week), whether or not the spouse is in the labor force, while women's total work is now nearly *60 hours* per week. Evidently, all of the change in total hours of household work results from women changing their mix of hours as well as their total hours.

Figure 3 illustrates total work, market work, and home work for husbands and wives for the two different types of households. Panel B shows that hours of market work for women working full time has been drifting up over time, while for men it fell until about 1983 and has been rising since. Compared to 1976, for two-worker households, women in 1988 work about two more hours per week in the market and men about one more hour. In terms of home production, women in 1988 work about four hours per week less than in 1976 and men about 1.3 hours more. Even though both are working full time in the market, women worked about 3.3 times as many hours in the home as men did in 1976, but this number fell to about 2.1 times as many hours in 1988.

One factor that is often said to affect the distribution of hours is the increase in the market labor force participation rate of women. Looking at households where the husband is in the market labor force, 46.6 percent of wives were in the market labor force in 1976 and 61.3 percent in 1988. The market labor force participation rate for married men, on the other hand, has remained fairly stable at about 83 percent.

Also, the increase in the share of married women participating in the market labor force is not just a phenomenon of younger cohorts. If we look at the same individuals from 1976 through 1988, we find similar results: a jump from 48.5 percent to 59.9 percent. Again, this may stem from a change in relative productivities in the market and home sectors and the ability to substitute one type of work for the other.

FIGURE 1 HOURS OF WORK

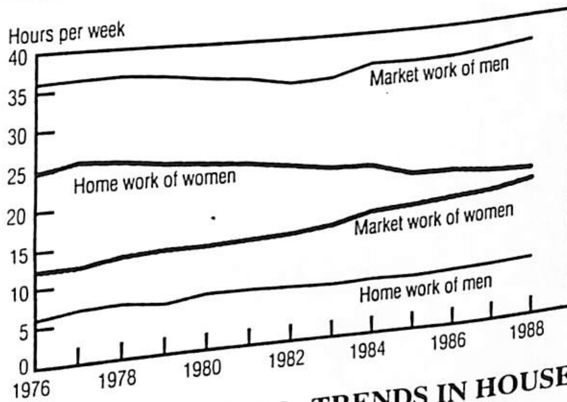
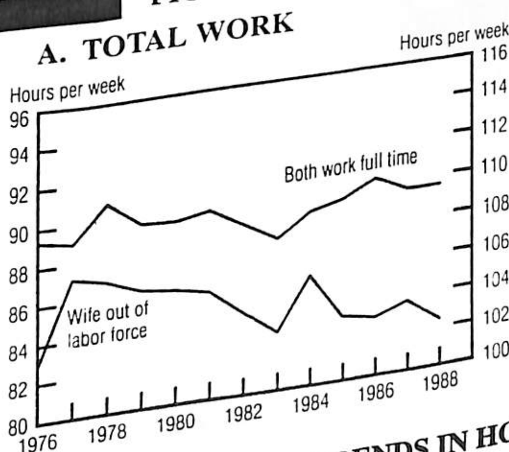
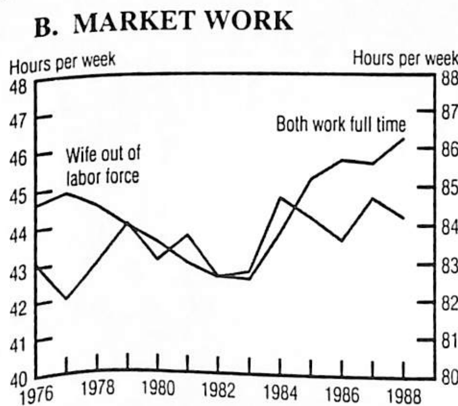


FIGURE 2 TRENDS IN HOUSEHOLD HOURS (MARRIED COUPLES)

A. TOTAL WORK



B. MARKET WORK



C. HOME WORK

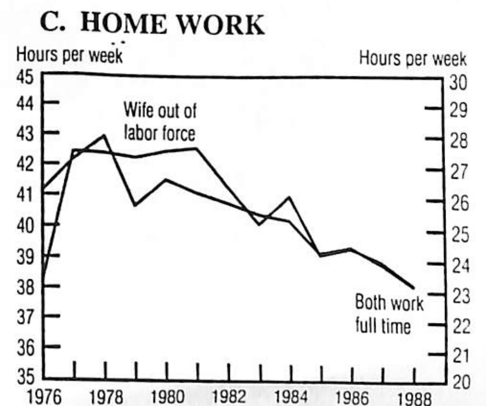
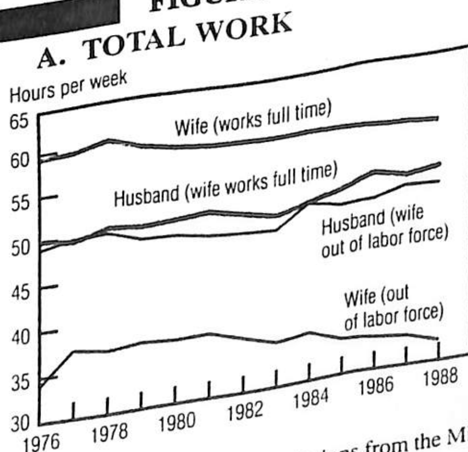
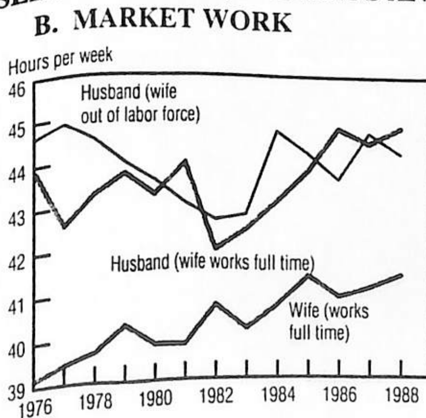


FIGURE 3 TRENDS IN HOUSEHOLD HOURS (HUSBANDS AND WIVES)

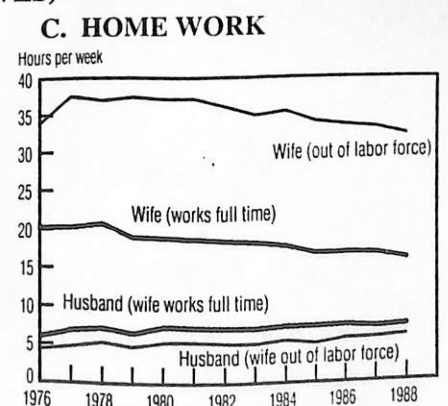
A. TOTAL WORK



B. MARKET WORK



C. HOME WORK



SOURCE: Authors' calculations from the Michigan Panel Study of Income Dynamics.

Conclusion

Although total hours of annual work did not change much from the mid-1970s to the late 1980s, the composition between market and home hours of work was dramatically affected. Nearly all of this shift can be attributed to women changing their hours. Moreover, the difference in hours of total work between households with wives working at home and those with wives in the market labor force is also due almost entirely to changes in the total hours of women.

While our analysis offers no conclusions about the quality-of-life implications of these labor trends, it does make clear that the overall number of leisure hours has not declined for American families. We are simply spending more time working in the marketplace and fewer hours in home production. In that regard, we should cast a wary eye on reform proposals that would intervene in the labor market to remedy a leisure time shortage that does not exist.

Footnotes

1. See, for example, Juliet B. Schor, *The Overworked American: The Unexpected Decline of Leisure*. New York: Basic Books, 1992.

2. See Gary S. Becker, "A Theory of the Allocation of Time," *Economic Journal*, vol. 75 (September 1965), pp. 493–517; and Reuben Gronau, "The Intrafamily Allocation of Time: The Value of the Housewives' Time," *American Economic Review*, vol. 63, no. 4 (September 1973), pp. 634–51.

3. See Jess Benhabib, Richard Rogerson, and Randall Wright, "Homework in Macroeconomics: Household Production and Aggregate Fluctuations," *Journal of Political Economy*, vol. 99, no. 6 (December 1991), pp. 1166–87, for the former; and Peter Rupert, Richard Rogerson, and Randall Wright, "Estimating Substitution Elasticities in Household Production Models," *Economic Theory*, forthcoming.

4. We begin in 1976 (although the PSID begins in 1968) to maintain consistent questions throughout all years because some questions were not asked prior to 1976.

5. Market work refers to annual hours of work on all jobs, including overtime. To make the numbers easier to interpret, we simply divided annual hours of work by 52 to get weekly hours. Therefore, it is irrelevant whether the change comes from increased hours per week or more weeks per year.

6. We have not looked at the behavior of women as men change their labor force status because the sample is quite small when we restrict it to men not in the labor force.

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The views stated herein are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

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REVIEW & OUTLOOK

Take 'Fairness' Head-On

This being tax week in the House of Representatives, Congressional corridors will ring with talk of "fairness." The whole purpose of the tax code—at least in the minds of Democrats, press commentators and Rep. Steve Gunderson (R., Wis.)—is to make sure that "the rich" pay their "fair share."

In what passes for debate, the issue of what is "fair" is usually resolved Samuel Gompers style—to wit, "more." But it might be instructive to interrupt the philosophy with a few purely empirical observations. What share do the rich, somehow defined, actually pay? Happily or not, the Internal Revenue Service spews out reams of statistics on income. It even has a quarterly publication, the SOI Bulletin. The Fall 1994 edition, running 212 pages, reports on tax returns for 1992.

'The Rich': Taxes Paid, 1992

ADJUSTED GROSS INCOME	RETURNS (mil.)	FED. INCOME TAX LIABILITY (bil.)
Total	115.4	$503.9
$100,000 and up	3.8	197.4
% of Total	3.3%	39.2%

Source: Internal Revenue Service, Statistics of Income Bulletin, v. 14, no.2, Fall 1994, table 2.

Of course, defining "the rich" is itself a problem. The received wisdom seems to be anyone with income of more than $100,000. You can think of this number as husband and wife in two $50,000 jobs, or you can think of it as a Congressman's salary in round numbers. Making more than a Congressman is as good a mark of "the rich" as anything, we suppose.

By this definition, some 3.7 million families qualified as rich in 1992; they paid $197 billion in federal income tax, plus $59 billion in state and local taxes that showed up as deductions on their federal returns. Taxpayers in this income group accounted for 3.3% of returns, and paid 39.2% of all federal income tax collections. This was in 1992, the year before the Clinton retroactive tax increases.

Taking a more rigorous definition of "the rich," SOI table 3 shows 67,243 taxpayers reporting adjusted gross income of more than $1 million. They paid more than $47 billion into federal coffers, amounting to 26.9% of their adjusted gross income, almost twice the average tax bite of 13.7%. Payments by these 70,000 families constituted roundly 10% of all income tax receipts.

Just who these millionaires are is an intriguing question. Probably not more than 500 of them are Fortune 500 CEOs. No doubt they include investment bankers and lawyers; strike suit king William Lerach, perhaps. Of course, others were baseball players now on strike. Mike Tyson may have dropped out of this circle momentarily while in jail, but seems firmly re-established with a new contract worth maybe $200 million. Perhaps promoter Don King is also one of the rich. Then, too, many of the millionaires are really businesses, Subchapter S corporations filing under a proprietor's individual return.

However defined, "the rich" clearly make an important contribution to federal revenues. But Mr. Gompers's cry for "more" runs up against a hard reality: the rich are few in number. There simply isn't much money, compared with the finances of the federal government, to be found in 70,000 millionaires or even the top 3% of taxpayers.

Take the 1992 returns. The group reporting incomes of more than $100,000 had total income of $858 billion. From this its members paid $59 billion in state and local taxes and took $88 billion in other deductions, then paid $197 billion in federal income tax. This leaves after-tax income of $512 billion.

'The Rich': Soaking Potential

Disposition of Income, returns with AGI of $100,000 and up, 1992

data from SOI bulletin, table 2

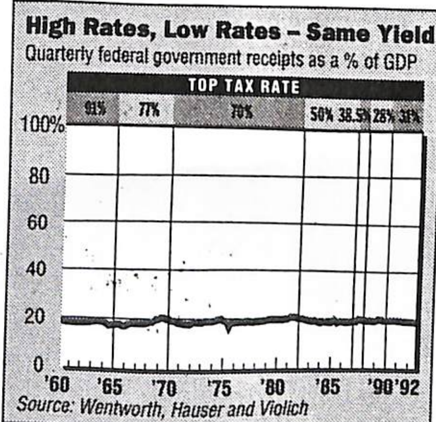
AGI (total, billions)	$858.1
State and Local Tax Deducted	59.4
Other Deductions	88.4
Taxable income	710.3
Fed. Income Tax liability	197.4
a rough calculation:	
After-tax income	512.9
less $100,000 per return	377.6
income over $100,000	135.3
1992 Federal deficit	290.4

Of course, the IRS can't confiscate the whole $512 billion, leaving 3.7 million families penniless; it has to let them keep something. So say it lets each family keep $100,000 in after-tax income, and takes 100% of any excess. Such confiscatory taxation, wildly assuming everything else held constant, would have produced $135 billion in extra revenues in 1992. In that year, federal spending was $1,380 billion, and the deficit was $290 billion.

Nothing important to government finance, in short, can be accomplished by making the income tax more progressive. While the largest source of government revenue, the personal income tax accounts for less than half of federal income; payroll taxes are nearly as large, and there is also the corporate income tax and other revenues. Within the income tax the progressive rates of course produce revenues, but scarcely a decisive amount in a trillion-dollar budget or six-trillion-dollar economy.

This point has been made graphic on this page by W. Kurt Hauser's famous 19.5% charts. Despite top income tax rates ranging from 28% to 91%, federal revenues have continued to hover around 19.5% of GDP. Those facing onerous rates find ways around them; in the large picture, revenue from "the rich" scarcely matters.

All of which suggests that during tax week in the House, there may be more important things to talk about.



The debate over whether a $500-a-kid credit ought to phase out at $200,000 or $95,000 is, well, childish. What Congress ought to be debating is how to structure the tax system to promote economic growth. As Mr. Hauser said, "Nineteen and a half percent of a larger GDP is preferable to 19.5% of a smaller GDP." The welfare of our children will depend a lot less on any tax credit than on whether we have a healthy economy.

As it happens, the new Republican majority in the Congress has a lot of ideas about the relation between taxes and growth. The child tax credit in the House "Contract" doesn't pretend to be a growth initiative, of course, but is billed as a cash remedy to the moral problems of illegitimacy and divorce. However, the "Contract" also named specific growth initiatives including, among others, a cut in the capital gains tax. Senate Republicans are interested in measures to cut taxes on returns to savings, as a method of increasing savings, investment and growth.

And, of course, the House is gearing up for a later debate on Rep. Dick Armey's flat tax, which combines all of these ideas. It would sharply pare the top marginal rate to boost economic incentives. But it would also include a generous family allowance, not only doing what taxes can to help families, but also retaining a progressive feature in effective tax rates. It would also exempt savings returns. And it's intended to drastically simplify the tax returns Americans file this month.

None of these ideas has any great prospect, though, so long as tax week is about fairness and the rich. The fairness debate had been suppressed by the political and economic success of the Reagan tax cuts, which offered and indeed produced rapid economic growth by reducing the high marginal tax rates that stifle incentives. "Fairness" reappeared under the aegis of former Senate Majority Leader George Mitchell in his filibuster victory over capital gains reduction in 1989, and has dominated tax debate since. Even the newly victorious Republicans have not cast off Mr. Mitchell's spell.

The Republicans are going nowhere with tax policy, we predict, until they take the "fairness" debate head-on and win it. Yes, if you have a tax cut it will benefit the people who pay the most taxes. But the real issue is whether it will benefit the economy, providing a bigger pie to share among the rich, the poor and the government.