

## Who says economics research is dull and irrelevant?

Well, lots of people – and, often as not, they’re right. But don’t despair. With help from *The Milken Institute Review*’s staff of thousands, I’ve once again managed to collect smart stuff that bears a closer look.

### IF IT MOVES, TAX IT

Ordinary folks don’t like taxes because of the “distributional” effect – the fact that taxes leave them with less to spend. Economists are people, too. But they are inclined to focus on the “efficiency” effects of taxation. Virtually every tax changes the relative prices of goods and services, they say, and thereby distorts what is made and how. But some taxes are more inefficient than others.

Jerry Hausman, an economist at MIT, looks at levies on wireless phone services and pronounces them a wretched mess. Federal, state and local taxes collectively increase cell phone bills by 14 to 25 percent, he reckons, generating a bit less than \$5 billion annually in state, local and federal revenues. But in the process of shifting

this \$5 billion from private pockets to the public purse, Hausman estimates, roughly \$2.6 billion in potential output is lost. That is, the resulting disincentive to use cell phones costs consumers an extra \$2.6 billion beyond the \$5 billion in taxes by diverting resources away from their most valued uses.

Is this distortion greater than the distortion created by, say, broad-based income taxes and sales taxes that create disincentives to work? You betcha – largely because wireless phones are subject to “network externalities” that make cell phone service more valuable to me if others are connected. So taxes that inhibit the growth of the wireless network are especially inefficient.

Hausman estimates that an extra dollar of government revenue collected from wireless services costs the

economy something on the order of \$2. That’s two to four times more wasteful than broad-based taxes.

[“Efficiency Effects on the U.S. Economy From Wireless Taxation,” *National Bureau of Economic Research Working Paper 7281*. Can be downloaded (for a fee) from [www.nber.org](http://www.nber.org).]

### WELFARE REFORM (CONT’D)

One trouble with welfare reform – and the reason it was bitterly resisted by unions – is that the government-mandated addition to the labor force either lowers wages or raises unemployment. And since virtually all of the new labor lacks marketable skills, welfare dropouts compete directly with workers who benefited least from the prosperity of the 1990s.

That said, the timing of

welfare reform could hardly have been better. The demand for labor has grown significantly since the act went into effect in 1996. Hence, it is entirely possible that the market has expanded sufficiently to absorb all the new workers. What's more, the Earned-Income Tax Credit – Washington's awkward name for low-end wage subsidies – has been substantially beefed up in recent years, offsetting the negative impact of rising

labor supply on the incomes of unskilled workers.

Robert Lerman, Pamela Loprest and Caroline Ratcliffe of the Urban Institute in Washington analyzed the labor market impact in 20 bellwether cities. And their findings are mixed. Under a set of plausible assumptions about how many welfare recipients will enter local low-skill labor markets, they estimated that demand growth will clearly exceed supply growth in Atlanta,

Dallas, Indianapolis, Jacksonville, Phoenix and (of course) San Jose. At the other end, Baltimore, New York, St. Louis and Washington are likely to see rising unemployment among the low-skilled, compounding the woes of these older cities where unemployment was already high.

Does that mean welfare reform was a mistake? Hardly. But it should serve as a warning that low-skilled workers are the most vulner-

## Good Morning, Vietnam!

**O**ut of sight, out of mind. When was the last time you thought about Vietnam? To refresh your memory, Vietnam was the wretchedly primitive country that was able to fight the United States' armed forces to a standstill with only a little help from its Leninist friends. But after the war, this land of citizen soldiers had a lot of trouble making its economy work. Indeed, until the last decade, Vietnam was one of the poorest countries on the planet, ranking down there with basket cases like Nepal and Haiti.

But that's all changed – or at least is on the way to changing. Paul Glewwe, Michele Gragnolati and Hassan Zaman of the World Bank note that Vietnam's *perestroika*, which included both market reforms and an opening to foreign investment, led to 6 to 7 percent growth for much of the 1990s. And using data from two detailed household income surveys, the three economists discov-

ered that a rising tide has carried all boats: income distribution has not become less equal.

Of course, these improvements need to be put in perspective. As in most poor countries, the bulk of the growth has taken place in urban areas, and the growth probably has widened the income gap between northern Vietnam and the more westernized south. What's more, the economy has a long way to go: half of the rural population still lives below the poverty line.

But the broad-based growth of the 1990s does bode well for social stability, increasing the probability that Vietnam will make a relatively smooth transition to capitalism and prosperity. Markets, as usual, are proving mightier than AK-47s. [*Who Gained From Vietnam's Boom in the 1990s?* World Bank Working Paper 2275. Download free from [www.worldbank.org](http://www.worldbank.org).]

able to an economic slow-down. And regardless of what we'd like to think, the recession-free economy will not always be with us. [*How Well Can Urban Labor Markets Absorb Welfare Recipients,* New Federalism series A-33. Download free from [newfederalism.urban.org](http://newfederalism.urban.org).]

## GENERATION WARS

**A**s one distinguished economist-journalist put it, "Social Security is a Ponzi scheme with socially redeeming features." In their latest exercise in "generational accounting," Jagadeesh Gokhale of the Federal Reserve Bank of Cleveland and Laurence Kotlikoff of Boston University show just how far that Ponzi game has progressed.

Washington's decision to finance the first half-century of Social Security on a pay-as-you-go basis has left the system with an actuarial deficit in the ballpark of \$8 trillion. Hence, short of a decision to fund the budget deficit by borrowing from the public, the gap must be closed by raising taxes on current and future workers or by reducing benefits to retirees.

Either way, it's a bad deal for those not yet retired. An

## In the Footsteps of Giants

**N**ot so long ago, small countries felt it was almost as important to have independent currencies as it was to have their own national flags and airlines. But for a variety of reasons, the worm has turned. The currencies of a dozen countries ranging from Costa Rica to Hong Kong formally or informally "track" the United States dollar. Another dozen ranging from Bulgaria to Iceland tracked the German mark until it was absorbed into the euro bloc.

Patrick Honohan of the World Bank and Philip Lane of Trinity College in Dublin note that the euro has already inherited the D-mark trackers and is likely to attract a host more trackers – mostly small countries on the geographic periphery of the European Monetary Union. Is this a good thing? Should the EMU encourage or discourage tracking?

The 1997 collapse of most of the Asian currencies that tracked the dollar suggests that "benign neglect" is probably not a wise policy, say Honohan and Lane. One way or another, a sudden change of value in a tracker's currency will have an unwanted impact on the trackee. Indeed, while they don't offer an explicit prescription, the two economists plainly believe that the EMU should offer support against instability to trackers in return for a considerable say in their fiscal and monetary policies.

Sounds as if these guys are reconciled to – maybe even pleased with – the prospect of the rise of regional currency blocs built around the dollar, yen and euro. [*"Pegging to the Dollar and the Euro," International Finance, November 1999.*]

immediate payroll tax increase of 38 percent without a change in benefits would raise the baby boomers' net loss (benefits less taxes) from 5.3 percent to 5.7 percent of every dollar of lifetime earnings. And it would be an even worse deal

for future workers born between 1995 and 2000: their net loss would rise from 5.4 percent of lifetime earnings to 8.1 percent. A benefit cut, by contrast, at least has the virtue of hitting all non-retirees equally.

So, what should we be

rooting for? No amount of twisting and turning will change the reality that the first waves of retirees under Social Security are living well at the expense of future retirees. However, if labor productivity and wages rise sufficiently over the next few decades, the burden will be a lot easier to bear. It's also worth rooting for a continuing boom in equity prices that feathers the nests of private pension plans – and thereby makes life brighter for those who will have to pay for the retirement of

others. [*Social Security's Treatment of Postwar Americans: How Bad Can it Get?* National Bureau of Economic Research Working Paper 7362. Can be downloaded from [www.nber.org](http://www.nber.org).]

## BETTER LIVING THROUGH PHYSICS

**C**ooking your hamburgers until they're gray and leathery? Washing supermarket chicken as though your life depended on it? Afraid to order a Caesar salad because

it's made with raw eggs? Food poisoning, always an issue in America, never seems to be far from the headlines these days. And it's driving gourmands – not to mention the public health establishment – plum crazy.

But as Randy Lutter, a fellow at the AEI-Brookings Joint Center for Regulatory Studies, points out, the technology for eliminating food-borne pathogens is out there for the asking. The only hitch: the regulators whose job it is to keep the poisons out of the food supply are

## Drowning in Cash

**I**f you're over 40 and took an introductory economics course in college, the term "liquidity trap" should be vaguely familiar. It comes from John Maynard Keynes's efforts to explain why monetary stimulus appeared to be so ineffective in pulling the world economy out of the Great Depression. (Remember the analogy to "pushing on a string"?)

The liquidity trap has popped up now and again, mostly in the context of rather sterile partisan debates over the value of Keynesian ideas in modern (postmodern?) economics. But the latest revival, by Paul Krugman of MIT, should be taken very seriously, indeed. Krugman, who's as good an economist as he is a journalist (which is saying something), believes that Japan is caught in precisely the sort of Depression-like deflationary spiral that makes the liquidity trap relevant.

There's a catch here, though. Keynes said the only way out of a liquidity trap was through fiscal policy – that is, for government to feed public and private demand with tax cuts and/or government spending. But Japan is rapidly using up that option, running budget deficits so large that private capital markets are reluctant to absorb the securities.

Krugman has a lovely "explainer," which lays out the arguments for a liquidity trap and the unintuitive import for public policy, posted on his personal Web site. It's tough going for non-economists, but worth the effort. And the Web site has lots of stuff posted that requires no particular expertise, including many of his columns from *Slate* and *Fortune* magazine. [*Thinking About the Liquidity Trap.* Unpublished paper can be downloaded free from [web.mit.edu/Krugman/www](http://web.mit.edu/Krugman/www).]

in the way.

Well, it's a little more complicated than that – but not a lot more. According to the World Health Organization and even the U.S. Food and Drug Administration, food irradiation would be a cheap, safe and very effective way of preventing millions of cases of food poisoning, minor and major, each year. Yet just a tiny fraction of the at-risk food supply is irradiated today.

In some cases, irradiation changes the taste or smell of food. But the primary reason more food isn't sterilized with radiation is that consumers are afraid of it and the Department of Agriculture (which shares regulatory responsibility with the Food and Drug Administration) is afraid to get out in front of popular opinion by encouraging food producers to make the switch. In fact, the only foods to be approved for irradiation thus far are poultry and spices. Decisions on seafood, eggs and precooked meats – big sources of poisoning all – are years away.

Why is this a matter of economic policy? Strictly speaking it isn't. But economists seem to be the only social scientists who are passionate about risk-reward tradeoffs in regulation. For

the question here isn't whether irradiation is absolutely, positively risk-free, but whether it is less risky than business as usual. [*Food Irradiation – the Neglected Solution to the Problem of Foodborne Illness,* *Policy Matters 00-1. Download free from [www.aei.brookings.org](http://www.aei.brookings.org).]*

### POTEMKIN FED?

**S**uppose Chairman Alan orders an end to the party and the band plays on? Suppose the Federal Reserve moves to temper economic demand by tightening credit, yet the economy keeps growing and growing?

This is no joke (at least as of this writing). The “real” economy, which has been expanding faster than even the optimistic estimates of the maximum growth rate consistent with stable prices, has yet to respond to Dr. Greenspan's mix of cautionary words and higher interest rates.

In a prescient paper delivered last July, Benjamin Friedman of Harvard suggested that the influence of central banks over economic activity is waning because the ability to create credit in contemporary economies is slipping beyond the central banks' control. That's because the primary source

of central bank power – the government's monopoly over the supply of private bank reserves – matters less and less since borrowers can elude the impact through the use of everything from credit cards to short-term debt markets.

How much should we care? Certainly, the implied paradox is worth noting: most economists believe that central banks have largely been responsible for stopping inflation in the last two decades, even as their power to determine the amount of liquidity in the economy has apparently waned.

The big question is whether we can get along without a strong monetary authority at the helm. If we can't, regulatory authority over credit creation in non-bank markets will have to be expanded. And hardly anyone who believes that the success of the American economy in recent years is linked to the exceptional freedom and efficiency of its capital markets is looking forward to more government intervention. [*The Future of Monetary Policy: the Central Bank as an Army With Only a Signal Corps?* forthcoming in Richard Cooper and Richard Layard (eds.), *Social Science and the Future*, MIT Press.]

— Peter Passell