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LBJ JOURNAL OF PUBLIC AFFAIRS

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FROM THE DEAN

During the past couple of years, I've learned a lot about other schools of public affairs around the country, and about other schools and colleges at UT. What I've concluded is that the LBJ School is an extraordinary institution. We have high quality faculty, competent and dedicated staff, and energetic, committed and intellectually vigorous students.

Our graduates are finding good career opportunities. This year, five current LBJ School students and two recent graduates took the rigorous Foreign Service exam; all seven were invited to join the Foreign Service. Of the 18 LBJ School students nominated for the prestigious Presidential Management Intern program, 16 were selected. These phenomenal success rates indicate how well we prepare our students.

LBJ graduates from the 70s and 80s are attaining positions of great power and prominence. Colorado Governor Bill Owens ('75) is the first LBJ graduate elected to serve as a state's chief executive. Jan Hart Black ('75) just became President of the Greater Dallas Chamber of Commerce, after compiling a record of success in local government and private business. Social Security Commissioner Ken Apfel ('78) is the recipient of the first UT Graduate School Distinguished Alumnus Award. And investment banker Kim Goodwin ('86 M.P.Aff. and M.B.A.) is a recipient of this year's Outstanding Young Texas Ex Award.

The LBJ School's success is traceable to three distinctive features of our program. The first is our ability to provide students a rich mix of academic rigor and practical experience—a mix personified by Professor *Emeritus* Ray Marshall, a distinguished economist and former Secretary of Labor. Our graduates are highly marketable because employers know that they can hit the ground running; they don't have to spend months learning to adjust to "real life." Our second strength is the joint degree programs—eight of them, all with partner colleges that are as strong in their areas as we are in ours. It's tough to beat a professional degree that combines the strengths of the LBJ School with those of the UT Graduate School of Business, or the Institute of Latin American Studies, for example. The mention of ILAS leads me to a third strength: Latin America. UT has more experts on Latin America than any other US university, and about a quarter of the LBJ School's faculty have expertise in that region.

The LBJ School is very good, but it can be better. We are working on initiatives that can move us into the very top ranks. One initiative, creating a new Center for Ethical Leadership, is inspired by the example and teaching of one of our most renowned professors, the late Barbara

LBJ SCHOOL OF PUBLIC AFFAIRS

The Lyndon B. Johnson School of Public Affairs was established in 1970, fulfilling a long-held dream of President Johnson for an academic institution aimed specifically at preparing talented men and women for leadership positions in public service. The school offers a master's degree in public affairs and a Ph.D. degree in public policy. For more information, write to the Office of Student and Alumni Programs, LBJ School of Public Affairs, Box Y, Austin, Texas 78713-8925, or visit the school's web site at http://www.utexas.edu/lbj.

Jordan. Another initiative involves developing a program in nonprofit management, philanthropy and volunteerism.

These and other ideas flow out of our basic purpose, which is to prepare our graduates to shape and manage the public's business. The public's business isn't conducted solely in government agencies; functions of great public import also are carried out by private businesses and nonprofit organizations. We want our graduates to perform well in any of these environments.

In order to fulfill our potential, we must raise $30 million over the next five years. Raising that much money will require, among other things, mobilizing more of our graduates. I have met hundreds of LBJ School alumni. They are enthusiastic about the School, some of them have been very generous toward it, and many others are looking for ways to help. We need to do a better job of engaging them.

Thanks to all of you for your dedication to the LBJ School, and for your support. This is a great place because you care about it, and about one another.

Edwin Dorn
Dean

From the Managing Editor

The Spring 1999 volume of the *LBJ Journal of Public Affairs* marks the eleventh year of the *Journal*'s publication. In addition to producing the *Journal,* the Editorial Board has expanded its role in bringing student work to public view through the inaugural edition of the *LBJ Forum*, an on-line magazine and interactive Web site. The *LBJ Forum* features additional policy research and analysis from members of the LBJ School community. The articles and editorials of the *LBJ Forum* are updated periodically throughout the school year. It can be found on the *Journal*'s regular Web site (see sidebar).

In the Practitioner's Corner of this year's *Journal,* we are pleased to include the Commencement Address from the LBJ School's May 1999 Graduation Convocation. This year's address was presented by the Honorable Kenneth S. Apfel. Mr. Apfel is the Commissioner of the U.S. Social Security Administration and a member of the LBJ School graduating class of 1978.

The student articles in this year's issue capture much of the diversity of interests of the LBJ School student body. The authors apply their skills of analysis to studies of globalization, metropolitan income inequality, electronic commerce in the public sector, changing welfare politics of US Presidents, the provision of insurance in blighted communities, and the European Economic and Monetary Union. We hope that the breadth of subjects addressed through this volume serve as the basis for stimulating discussion, and hopefully debate, over the role of government and public policy in our lives.

The publication of this volume would not have been possible without the resources and time of many people. We owe thanks for the advice of Dean Edwin Dorn and our faculty advisor David C. Warner. We are grateful to Bob Vargas and Don Wallace of the LBJ School Business Office for their budgetary and logistical support, and Marilyn Duncan, Doug Marshall, and María de la Luz Martínez of the Publications Office for their invaluable production assistance. Most importantly, we thank the LBJ Foundation for their continued financial support of the *Journal*.

H. Whitt Orsburn

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FIND YOUR LIFE'S PASSION IN PUBLIC SERVICE

COMMENCEMENT ADDRESS DELIVERED AT THE LBJ SCHOOL OF PUBLIC AFFAIRS GRADUATION CONVOCATION ON MAY 21, 1999

BY KENNETH S. APFEL,
COMMISSIONER OF SOCIAL SECURITY

Kenneth S. Apfel has served as the Commissioner of the United States Social Security Administration after confirmation by the Senate on September 19, 1997. Prior to becoming Commissioner of Social Security, Mr. Apfel served in the Office of Management and Budget in the Executive Office of the President, the Department of Health and Human Services, and the office of U.S. Senator Bill Bradley. In 1970, Mr. Apfel received a bachelor's degree from the University of Massachusetts, and in 1973 earned a master's degree in rehabilitation counseling from Northeastern University. In 1978, Mr. Apfel received a Master of Public Affairs from the LBJ School, and was among the first group of Presidential Management Interns to begin working for the federal government.

DEAN DORN, DEAN SHERMAN, DEAN ROSTOW, faculty, staff, friends, guests—and especially graduates: It is an honor to receive the University of Texas 1999 Distinguished Alumnus Award. I feel doubly honored today to also have been asked by the graduates of the LBJ School to speak at their commencement, and to be here with students who have chosen public service careers.

Almost a quarter century ago, I successfully convinced Dagmar Hamilton and the Admissions Committee that the LBJ School experience was just what I needed to make a larger contribution. And twenty-one years ago this month, Dean Rostow gave me that ticket when she handed me my degree—a degree that I have been very, very proud of ever since.

I have said dozens and dozens of times in my life that the LBJ School was the real turning point for me—giving me the skills and the confidence to make a contribution in the public arena. Whether it was struggling to succeed in Lodis Rhodes' policy research project, or learning about leading in Ken Tolo's policy research project, or listening to Lady Bird Johnson at the ranch talk about service, or spending hours and hours in my study carrel - or hours and hours at El Rancho Restaurant with my future wife—I left prepared.

I've never for a second regretted my educational choices, and neither—I think—will you.

Whether you want to be an administrator of public programs, a policy wonk, a budget analyst, or a politician—whether you lean left or lean right—the rewards and the challenges of public service are real, and the capacity to make a real difference is unequaled.

Harry Truman once said, "We can never tell what is in store for us." I can tell you that while I came to the LBJ School with a passion for social policy, I wouldn't have dreamed that one day I would be custodian of what I believe to be the most important legacy of the New Deal.

It has been an enormous honor and challenge to serve as Commissioner of Social Security, particularly now, as we stand on the edge of a new century. Particularly now, when our government institutions face such real challenges. And particularly now, as we debate—again—what our collective responsibilities are to one another.

The future of Social Security is again at the center of our national discussion, just as it was over a half-century ago.

Today, I am not here to quote line and verse on how to strengthen the Social Security program for future generations. But I will tell you that my own life's lessons as a public official have made clear that one way to strengthen the fabric of our country is by strengthening our government institutions, such as Social Security . . . and I will tell you about the pivotal role that skilled and committed individuals—such as you—can play in our national life.

President Johnson once said that "you will find meaning only by sharing in the responsibilities, the dangers and the passions of your time." The history of this century has largely been written by those who have passionately believed in an idea, in a cause, and by those who have devoted their energies to realizing their ideals.

Social Security was created by women and men with that passion for change.

At the turn of this century, in my own home town of Worcester, Massachusetts—a factory town—there was a young woman who, when she enrolled in college, thought that she would take the easier courses offered, have a good time and enjoy campus social life.

But she was touched by the struggles of ordinary Americans and the poverty of older Americans, and it didn't take long until she found that issues larger than herself were paramount. She graduated as class president and went on to become our first female cabinet member and the driving force behind the creation of the Social Security program. That woman was Frances Perkins.

Now, during the very first year that Frances Perkins was Labor Secretary, there was a young college student in Wisconsin with a passion born of the economic struggles of the working class that he grew up with. After college, he went to Washington as a research assistant to the Congressional Committee that was then drafting the original Social Security Act.

In later years, he liked to say that he was the very first employee of the Social Security Administration. That young man was Wilbur Cohen. And, by happenstance, he found his life's passion. He became the most articulate, most respected spokesperson for progressive social policy in the country. He went on to become Secretary of Health, Education and Welfare, and later in life to serve as Professor here at the LBJ School. He left an enduring mark—not only on Social Security, but in helping President Johnson build the Great Society.

Well, Frances and Wilbur helped to create one heck of an institution for America. Our very first field office in the country opened up in 1936 right here in Austin. It was in the old Post Office Building. We were still four years away from paying the first monthly benefit, and there were only a half dozen, curious visitors to our first office, that very first day in Austin, Texas.

Sixty-three years later, more than 44 million Americans receive monthly Social Security benefits. And each year 26 million Americans visit one of our 1,300 field offices, including our office still located in downtown Austin.

The fabric of the country has been changed by Social Security, as it has by all of our key institutions. And that monthly Social Security check has become the mainstay behind the near eradication of poverty among most of the elderly. It is—unquestionably—the most important antipoverty program in our Nation's history. Indeed, if Social Security were gone today, half of all older Americans would be living in poverty tomorrow.

We can and should rejoice in our successes. But this is 1999, not 1936, and Social Security faces some very real pressures, born of continuing demographic changes. When the Social Security program was created in 1935, the average life expectancy of a 65-year-old was 12 and one-half years; today it's 17 and one half—and rising.

Within the next thirty years, the number of older Americans will double, placing very real strains on our retirement system.

Will Social Security be there in the future as a solid foundation that can be counted on in retirement? Of course it will, and our Nation's economic strength gives us a real opportunity to strengthen Social Secu-

rity. But change won't just happen. For those who are serious about governing, we have to confront challenges honestly and directly. And doing so raises tough questions. Will current retirees and members of my generation enjoy a secure retirement? How can we ensure that we don't unfairly burden younger generations? And how do we do so in ways that strengthen the fabric of our society?

And, pragmatically, how do we get from here to there? How do we make sure that we don't just "kick the can down the road" 20 years and wait for those of your generation to handle it?

Not easy questions—but those are the public questions for our generations to answer.

In any democratic society, the establishment and continuance of any major public institution depends on its ability to win and maintain public support. For a program as important as Social Security, we need broad-based legitimacy—across generations, across income groups and over time. Our institutions have to be able to deliver on the big issues of the day.

It's a challenge to each and every one of us in public service, and to all of those who will enter public service careers: how to ensure that our institutions work. That is as true of Social Security as it is for the Texas public school system, or the city of Austin's electric department and all other major public institutions.

I believe all of us in public service need to focus on a number of key areas to strengthen our public institutions:

First, we need the public to be part of our process. Barbara Jordan once observed, "The stakes are much too high for government to be a spectator sport."

She couldn't have been more right. And she couldn't have been more profound.

Supreme Court Justice Stephen Breyer recently noted that "the Constitution creates a method for making decisions; it then leaves decision-making to the democracy that it creates. For this reason, the Constitution demands participation by the public. And without trust and participation, the Constitution cannot work."

Rey Rodriguez, who is graduating here today, saw public participation firsthand. On his internship last summer, he went with me to Albuquerque, New Mexico to participate in one of President Clinton's national—and bipartisan—town hall meetings on the future of Social Security. Americans need to be involved in discussions about the future of our nation's retirement system and our collective responsibilities.

And that's why we at Social Security have held more than 5,000 public education events and media opportunities on the future of Social Security—joined by people on all sides of the philosophical and age spectrum— to involve Americans in their future.

Government institutions need to be active in educating the public about critical issues, and encouraging their active participation in the process. But that doesn't happen automatically. It takes hard work, by many people.

Second, our institutions need to meet real needs. And to do so we need an openness to new ideas and a cadre of highly skilled professionals, not only with passion for their field, but also with the skills and abilities to objectively assess options for change to better meet the needs of our citizens.

It reminds me of a young Social Security employee, Sophia Wright, who came to Washington as a Presidential Management Intern after graduating two years ago from the LBJ School. Sophia came to the LBJ School after working with the elderly and the disabled as a claims rep in that little Social Security office in downtown Austin. She is now using the skills that she learned here at the LBJ School to help define how continuing demographic and economic changes affect the role that Social Security plays in the lives of women. And her work has helped define the policy options available on this issue.

I hope that through our collective efforts—and her analysis—that future Social Security Commissioners won't have to say that one in five widows in America still lives in poverty.

So we need the right structure for our programs for the times, designed by skilled people who help to define policy, and we need the public to be part of the process . . . but we also need more.

Another key to legitimizing our government institutions is quality service to the public. There is a strong correlation between performance and public confidence in government. When we make government work, public confidence and trust in government rises.

Over the last few years, confidence in our institutions has been on the rise. But we still have a long, long way to go. The graduates of public policy and public administration schools have helped agencies strengthen the activities which improve government efficiency, accountability and public service.

That's part of our public trust.

Frankly, we have to provide good service at Social Security. When you get more than 60 million phone calls a year on our 800 number, you'd better be able to answer questions quickly and accurately, and have accountable managers focused on customer service and results.

When you have 44 million Americans counting on that monthly Social Security check to be there—many

who are living month-to-month—you'd better make darn sure that the Y2K bug won't interrupt those payments, even by a day.

When a million severely disabled children rely on your agency for support, you need to be able to ensure fair, courteous and responsive service to meet their needs.

And with 150 million Americans paying into the system, you need to develop tough but fair anti-fraud and program integrity measures to assure accountability of scarce public resources. And somehow you must find a way to do it all without breaking the bank. That's also part of our public trust.

There is one last area that I believe we need to continue to address. We need to do all that we can to see that our institutions reflect the people that we serve. By the middle of the 21st century, our country will not only be older, it will also have no racial or ethnic majority. No other nation in the world will go through demographic changes of this magnitude in so short a time.

Last year, I participated in a naturalization ceremony in San Antonio. Hundreds of Asians, Africans, Hispanics, Europeans, all becoming Americans. I remember the faces glimmering as a 100-year-old woman from rural Mexico rose—with assistance from her family—to take the oath and become America's newest citizen. I was deeply moved.

It really is a wonder that for hundreds of years people from so many different parts of the world can dream of, and then actually become, Americans.

This diverse America is our service population. Whether we are Social Security, the Texas public school system or the city of Austin's electric department, we need our institutions to serve our changing population. And to better serve a more diverse population, we need to become more diverse organizations . . . to look like America.

I have a picture in my office of President Johnson visiting Social Security headquarters in Baltimore. He's surrounded by a dozen of SSA's top executives, including Wilbur Cohen and Robert Ball. Every one a male, every one white, and every one at least middle-aged.

The picture of my agency's leadership is changing. And so are my senior managers and my workforce. But such change does not "just happen." It only happens when men and women of skills and passion and conviction make it happen.

We all need to strengthen our institutions, whether we are administrators of public programs, policy wonks, budget analysts or politicians. Whether we lean left or right. Even if we are private citizens.

A few moments earlier I noted that we now stand on the edge of a new century. I'm sure that the 21st century will prove to be as uncertain as the past century has been. But this I know to be certain: the coming century is *your* century.

I'll be counting on your generation. We all here will be counting on your generation, to provide the skills and passion and conviction needed to shape the future, to strengthen our institutions, and to serve the public.

In closing, let me again quote President Truman: "We can never tell what is in store for us." When I walked across this stage 21 years ago, I could not have predicted my future—or my country's future. But I knew I wanted to share in, as President Johnson said, "the responsibilities, the dangers and the passions of our time." And my degree unlocked that door.

Of course, no one can tell what your century holds in store. But when America last stood on the brink of a new century, no one could know that such individuals as Frances Perkins, Wilbur Cohen, Lyndon Johnson, Barbara Jordan—and so many others—would follow their life's passion into the public arena and write the destiny of the 20th century.

You can do the same in the coming century. And you will.

To the graduates here today: I'm so proud that you have chosen a life in public service. And to the guests of the graduates here today—parents, spouses, loved ones, children—be very proud of them. They have chosen a path to benefit you—to benefit all of us. We all thank you, the graduates, for choosing this path.

LBJ

Poverty, Policy and Presidential Power:

An Examination of the Welfare Reform Policies of the Nixon and Clinton Administrations

by Adam Thomas

Adam Thomas is a second-year student at the LBJ School of Public Affairs. He graduated magna cum laude *in 1995 with a Bachelor of Arts in political science from Birmingham-Southern College. His academic interests include research methods, welfare and education policy.*

In January of 1969, Richard M. Nixon was inaugurated as the 37th President of the United States. In an essay published that month in *The Progressive,* Professor Reo Christenson of Miami University predicted that, "with Richard Nixon as president, the nation can expect few significant initiatives on the poverty front."[1] Indeed, if anything, one might have expected a scaling back of the programs already in place. During his presidential campaign, Nixon proclaimed that, "for those who are able to help themselves—what we need are not more millions on welfare rolls—but more millions on the payrolls in the United States of America."[2] A number of dramatic approaches to welfare reform were being discussed, including a guaranteed income and a negative income tax, but Nixon dismissed all of them, stating that he saw no "reasonable prospect" that he would advocate any such reform.[3]

In the opening phrases of his first major presidential address on welfare, Nixon remained true to form: "The present welfare system has failed us—it has fostered family breakup, has provided very little help in many

states and has even deepened dependency by all too often making it more attractive to go on welfare than to go to work." [4] It was only a few sentences later, however, that the President heralded a startling "new approach" to welfare policy. The cornerstone of this approach was the proposition that the federal government ought, in Nixon's words, to "pay a basic income to welfare families who cannot care for themselves. . . . I propose that we make available an addition to the incomes of the 'working poor.'" [5] Thus did the President who had once claimed that "what we need are not more millions on welfare rolls—but more millions on the payrolls" come to advocate the Family Assistance Plan (FAP), a welfare reform proposal which, by the estimate of his own staff, would have added 7 million people to the welfare rolls.[6]

Almost a quarter-century after Professor Chris–tenson's pessimistic prognostications, Tom Bethell of the *National Review* asserted that "there is not likely to be any welfare reform in the Clinton Administration." Despite Bill Clinton's repeated campaign pledges to "end welfare as we know it," Bethell predicted that any welfare legislation passed during the Clinton presidency would simply be "one more expansion of the welfare system" rather than a meaningful reform of it.[7] Others had already expressed similar premonitions. An October 1992 article in *The New York Times* claimed that then-candidate Clinton "has not committed himself on the crucial details that will spell the difference between significant and cosmetic change. And it is doubtful that the changes would be as bold as Mr. Clinton suggests once Congress, the bureaucracy and the budget weigh in."[8]

Notwithstanding these predictions, President Clinton signed a welfare reform bill on August 22, 1996 that, in his own words, "requires work of recipients, limits the time they can stay on welfare . . . demands personal responsibility, and puts in place tough child support enforcement measures."[9] Thus did the President from whom many expected nothing more than "cosmetic" reforms come to sign into law the Personal Responsibility and Work Opportunity Reconciliation Act, a bill which, according to *Time* magazine, "reversed 61 years of social policy by converting an open-ended guarantee of federal assistance . . . into a largely state-administered program with time limits on benefits designed to push most of the recipients into work."[10]

How is it that two of the most dramatic welfare reform proposals of the last half century drew the support of presidents who were expected to make little progress on the welfare front? More importantly, why is it that the Republican President advocated a sweepingly expansionist proposal, while the Democratic President signed a bill that marked the reversal of policies his party had supported for sixty years? The answers to these questions, when considered in tandem, paint a compelling portrait of presidential power in the late twentieth century. An examination of the welfare reform policies of the Nixon and Clinton eras teaches us two particularly valuable lessons. The first is that the influence of the modern presidency in the policymaking process is, to say the least, limited. The second is that a president's success as a policymaker and political tactician may be affected by his capacity to recognize these limitations and work within them in order to maximize the power of his office.

RICHARD NIXON AND THE FAMILY ASSISTANCE PLAN (FAP)

When Richard Nixon took office in 1969, the primary vehicle for providing subsidies to the poor was (and remained throughout his administration) the Aid to Families with Dependent Children program (AFDC). Although the program was funded federally, it was largely administered at the state level. State governments had a great deal of latitude in determining who would receive benefits, and in what form. In nearly half the states, assistance was denied to families in which the father was a member of the household. In other states, payments were disbursed only if the father was unemployed. These practices led to the accusation that AFDC encouraged fathers to abandon their families so that they could receive benefits.[11]

Another criticism of the program related to the wide disparities in benefits between states. Monthly payments at that time ranged from $720 in Mississippi to $4,332 in Michigan.[12] Consequently, critics claimed that the program was severely inequitable. Nixon acknowledged this problem in his speech introducing FAP, saying that, "In many areas, benefits are so low that we have hardly begun to take care of the dependent."[13] The President's plan sought to replace the AFDC system with direct payments undergirded by a minimum requirement of $1600 for all states.[14] The proposal also entailed stricter work requirements and an expansion of the food stamp program. The increases in total benefits (including food stamps) were designed to ensure that subsidies for a family of four totaled at least $2,464 per year.[15] The payments were to be disbursed to both the unemployed and the working poor. All families earning below $720 a year were to have received the full benefit, while half of any income earned above that threshold was to be applied to a reduction in additional benefits.[16]

Inherent in this proposal was the marked expansion of welfare provision in the United States. Three times as many children, for instance, would have been eligible for AFDC payments than was the case under the current system.[17] Historian Tom Wicker has written that, despite past promises to the contrary, "for the first time in American history, a president was proposing—though he carefully avoided the term—a guaranteed annual income."[18] The expansionist tenor and sweeping scope of the plan were a surprise to a great many people. According to historian Stephen A. Ambrose, when Nixon told his own cabinet about FAP, "nearly all were opposed, skeptical, shocked, or sat in stunned silence."[19] The benefit of historical hindsight sheds some light on this matter, indicating that the President decided to support FAP in part because he sincerely believed in the merits of the proposal, and in part because of the limitations inherent to his office.

"Although he empathized with the poor, Nixon despised the "bureaucratic class" whom he perceived to advocate their interests."

One of the most important reasons for Nixon's decision to support FAP was that it appealed to his genuine sense of sympathy for the poor, which was based at least partially upon his own experience. In a 1968 campaign film, he declared that "We were poor . . . We had very little. . . . We had to learn the value of money."[20] In a memorandum to speechwriter Ray Price, he recalled the challenges his family faced in his youth: "In the depression years I remember when my brother had tuberculosis for five years and we had to keep him in a hospital, my mother didn't buy a new dress for five years. We were really quite desperately poor."[21] Thus, writes Wicker, Richard Nixon "brought to the White House—though it was largely unrealized by the public . . . a considerable empathy for the poor."[22]

Although he empathized with the poor, Nixon despised the "bureaucratic class" whom he perceived to advocate their interests. This post-materialist class—well educated, well off, and politically active—bore the brunt of some of Nixon's most savage vitriol. The following quote, in which Nixon talks about social workers, exemplifies his penchant for dividing people into two clearly differentiable groups - one meriting compassion, and the other warranting reproach:

> They earn very good livings making the black poor feel put upon, when they are, which is often the case, and also when they are not. . . . On average, I would suppose, for example, that white women who teach Head Start children earn about three times as much per hour as the black men who fathered the children.[23]

The Family Assistance Plan allowed Nixon to give everyone what he perceived to be his or her just rewards. First, it entailed a substantial increase in funding for the poor, and second, to the extent that it streamlined and standardized the allocation of benefits, it limited the power of the bureaucracy. In the President's words, the plan was designed to "eliminate social workers' snooping which is essentially berating."[24]

The fact remains, however, that Nixon had once dismissed outright the possibility of pursuing anything so bold as FAP, and it is hard to believe that his empathy for the poor and his distrust of the bureaucracy were so compelling as to convince him spontaneously to change his mind. Rather, it seems more likely that his decision was affected by an array of factors of which these were only a few. Any examination of this affair would be incomplete, for instance, without considering the instrumental role played by the President's advisers. One of the most influential of those advisers was Daniel Patrick Moynihan, a Harvard professor whose work was introduced to Nixon by domestic policy adviser Martin Anderson.[25] A liberal Ivy League scholar with ties to both the Kennedy and Johnson administrations, Moynihan was not exactly the prototypical Nixon administration official. Nixon's original attraction to him was rooted in Moynihan's strident criticism of the welfare establishment and of the consensus upon which it was built.[26] Ultimately, however, Ambrose attributes the hiring of Moynihan to his personal charm: "Nixon, like most people, was drawn by Moynihan's gift for gab, by the brilliance of his mind, by his uncompromising honesty, by his pixie qualities, and the originality of his thought."[27]

Nixon appointed Moynihan to the chairmanship of the Urban Affairs Council (UAC), where he quickly forged an alliance with Robert Finch, Nixon's Secretary of Health, Education and Welfare (HEW). A faction formed within the administration in opposition to Moynihan and Finch's relatively liberal coalition. That faction was headed by economist Arthur Burns—Counselor to the President—and, ironically, Martin Anderson. Brookings Institution analyst A. James Reichley maintains that Nixon "deliberately set up competition between Burns and Moynihan as an administrative technique—like Franklin Roosevelt's practice of playing one adviser off against another."[28]

Moynihan and Finch began formulating plans to craft a welfare reform proposal involving a negative income tax. In March of 1969, Moynihan presented the Family Security System proposal to the UAC. A master rhetorician, he was able to pass off his sweeping proposal as moderate and uncontroversial. Anderson, who was present at the meeting, recalled that "Moynihan laid out this plan which was contrary to the whole thrust of the campaign and the administration, as I understood it. To my astonishment, all of the people sitting around the table . . . began nodding in agreement. They simply did not grasp that what he was talking about was a negative income tax."[29]

Burns formulated a rival proposal that established national welfare standards, mandated federal revenue sharing with state governments, and pushed for the expansion of federal work-training programs. The proposal represented a far less substantive break with precedent than did Moynihan's, and Secretary of Defense Melvin Laird criticized it as "an affirmation of the past."[30] In the end, Nixon turned to Secretary of Labor George Schultz for a final recommendation as to which of the two plans to select. Schultz recommended that the President adopt Moynihan's position while incorporating elements of the Burns plan into the final draft. Nixon agreed with Schultz's recommendation and gave the order to proceed as such. In its final form, the proposal, whose name was changed to the "Family Assistance Plan" in an effort to present it in more benign terms, involved both income support *and* national standards; it was both a reformation *and* an affirmation of the system already in place.[31]

"Clinton's critics pointed out that, for all the apparent specificity of his proposals, he had left himself considerable room within which to maneuver."

Moynihan's role was pivotal throughout this process. He was, to a large extent, responsible for Nixon's decision. He submitted numerous missives skillfully stroking Nixon's ego. He told Nixon that it was his destiny to play the role of an American Disraeli—a "Tory man with liberal policies."[32] He convinced the President that FAP would "strike a hard blow at the welfare bureaucracy."[33] He appealed in one memo to what Wicker describes as "the President's well-documented love for the big, jaw-dropping gesture" by writing in all capital letters that supporting FAP was "THE SINGLE MOST DRAMATIC MOVE YOU COULD MAKE."[34]

It is entirely possible that Nixon was *too* dependent upon the advice of his staff. Historian Joan Hoff-Wilson asserts that, by the time the debate over welfare reform reached its most contentious stage, "it had become impossible for the President to distinguish between impressionistic and substantive advice from his own staff."[35] Reflecting on his time in the Nixon administration, Arthur Burns claims that he was sometimes uncomfortable with the readiness with which the President embraced his opinion without prolonged consideration: "The President sometimes would accept my arguments without hearing them out. . . . This bothered me. . . . It was wrong of the President to make decisions without being fully acquainted with the problem."[36]

Burns' statement illustrates one of the limitations of the modern presidency and illuminates one of the traps into which contemporary presidents sometimes fall. Presidents must make decisions on a wide range of issues and are often compelled to rely heavily on others for information and analysis. Their authority is diminished to the extent that they stray from the fine line that separates effective delegation of decision making power from abdication of one's personal investment in those decisions. In this instance, it is clear that Moynihan played a significant role in Nixon's decision making process. It is an open question as to whether that role was *too* significant.

While Nixon's position on welfare reform may have been affected by those around him, the principles underlying FAP were not entirely out of sync with his own overarching conservatism. After all, the notion of a negative income tax was first forwarded by Milton Friedman, the patriarch of conservative thought in post-war America.[37] It is also important to remember, however, that President Nixon came to power during a period of dramatic public sector growth. The argument between Nixon and his political opponents was rarely about whether the government ought to expand or shrink; few questioned the merits (or at least the inevitability) of government growth. Rather, the debate more often centered on the question as to how much the government should grow, and at what rate. In response to FAP, for example, Democratic presidential nominee George McGovern proposed an even more expansive program with even higher subsidy levels.[38] One could argue, then, that to be a conservative during the Nixon era was to argue not for the dismantling of the welfare state, but for a different and more tempered incarnation of expansionism. Unable to recast the fundamental terms of the political debate of his day,

Nixon was constrained instead to work within its parameters. In this respect, his support for FAP was as much a simple acceptance of the political center of gravity as it was a bold stroke of leadership.

In the end, of course, President Nixon is not best remembered for his innovations in welfare policy. His historical legacy was of a different nature than he had either hoped or anticipated. Even had the scandal of Watergate not darkened his presidency, FAP was never destined to have been regarded as one of the highlights of Nixon's tenure in the White House, because it was never enacted. It was twice passed by the House and held up by the Senate Finance Committee, which refused to send it to the Senate floor for a vote. The full Senate then deleted a compromise version of the plan from a larger spending bill, effectively marking the end of the legislative life of the Family Assistance Plan.[39]

According to Wicker, "the overriding barrier to congressional approval [of FAP] was a strange but potent liberal-conservative alliance that sprang from the nature of the proposal."[40] Conservatives, he said, had numerous reasons to oppose FAP. Not least among them was the argument—forwarded fervently by Governor Ronald Reagan of California—that it was far too expensive and would encourage idleness among the program's beneficiaries.[41] Liberals, meanwhile, complained that the work requirement was too stiff, and that the subsidies were too small.[42] This odd coalition of Democrats and Republicans was strong enough to defeat the President's plan by ensuring that it never made it on to the Senate floor in a palatable form.

Nevertheless, political scientist Carl Lieberman maintains that, above and beyond the obstructive machinations of the bill's opponents, one must consider the wider context in which Nixon was attempting to make policy:

> If a president has a good working relationship with major constituencies - the electorate, his party organization, the news media, Congress, and the bureaucracy - he probably stands a better chance of overcoming the structural, political, and ideological obstacles that stand in his way. Unfortunately for Richard Nixon, either the relationships were never good, or they deteriorated during his second term as a result of Watergate.[43]

If Lieberman's claim is true, then the successful realization of an undertaking as momentous as FAP required more than the simple support of the Oval Office. Richard Nixon—a conservative President who had, throughout his political career, made enemies at a remarkable rate—had little hope of passing a major reform premised at least partly upon distinctly liberal dispositions.

Bill Clinton and the Personal Responsibility and Work Opportunity Reconciliation Act

Despite the Nixon administration's failure to secure the passage of FAP, the number of AFDC recipients remained relatively stable from 1971 to 1989. Nevertheless, that number swelled by 30 percent over the subsequent five years, and, by the time Bill Clinton took office in 1993, nearly one in every seven children was receiving welfare benefits. In total, fourteen million people were on the welfare rolls, and the annual cost of the program had grown to almost $26 billion. *Congressional Quarterly* reported that a broad consensus was developing among Democrats and Republicans alike that the system was broken and that "the time is ripe to attempt welfare reform."[44]

That President Clinton at least ostensibly embraced this consensus should have come as no great surprise. As a candidate, he promised to fulfill his pledge to "end welfare as we know it" by placing time limits on welfare benefits, expanding job training programs, sanctioning recipients who did not find work once their time limits had expired, and guaranteeing jobs to welfare recipients by offering them community service jobs in the absence of offers from the private sector. One could even find in Clinton's plans a distant echo of FAP—he proposed to guarantee all workers a minimum income by expanding the Earned Income Tax Credit (a tax credit for the working poor) in order to raise the earnings of all full time workers to at least $13,924.[45]

Later on in the campaign, though, he admitted that his proposals, which carried with them an estimated price tag of six billion dollars, might not be affordable.[46] Some critics pointed out that for all the apparent specificity of his proposals, he had left himself considerable room within which to maneuver. For example, he did not specifically define what "sanctions" he would impose upon recipients who did not find work within the allotted period of time. Nor did he say who might be exempt from the work requirements, or whether the job training programs would be mandatory for all AFDC recipients.[47]

President Clinton did little to assuage his critics' concerns during the early part of his first term. The five-year budget plan he released in April of 1993 was devoid of any mention of welfare reform.[48] The administration focused most of its attention during its

first two years on the ill-fated health care initiative rather than on welfare, prompting loud protests from Senator Daniel Patrick Moynihan (D-NY), who as chairman of the Senate Finance Committee (the very committee that had prevented the passage of the Family Assistance Plan), threatened to "hold health care hostage" until the administration produced a welfare reform bill.[49] "We don't have a health care crisis in this country," asserted Moynihan. "We do have a welfare crisis. And we can do both."[50]

The President did eventually formulate a welfare reform plan, which he unveiled in June of 1994. It was similar to the one he had proposed during his campaign, with a two-year time limit on benefits and an aggressive jobs program. *The Economist* claimed that the President's proposal amounted to "one of the most radical welfare plans ever proposed by an American president."[51] However, many conservatives were dissatisfied with it. The *National Review* complained that the work requirement amounted to only fifteen hours per week, and that it would apply to barely six percent of AFDC recipients because it was so riddled with loopholes.[52] Moreover, the proposal entailed spending increases that were unacceptable to many Republicans. According to *Congressional Quarterly*, "helping move people from welfare to jobs—with training, child-care help and other assistance—promised to cost the federal government more, not less. . . . And Republicans were looking at welfare reform as a way to save billions of dollars in federal spending."[53]

The President's plan made no legislative progress that year. After the midterm elections of 1994, the political landscape—and the nature of the debate over welfare - had shifted dramatically. Having assumed a majority in both houses of Congress, the Republicans made welfare reform a high priority. In late 1995, Congress passed the Personal Responsibility and Work Opportunity Reconciliation Act on largely party line votes. The bill imposed time limits on benefits, and via the mechanism of block grant funding, devolved to the states all responsibility for the provision of welfare services. Among the bill's more contentious components were provisions denying services to noncitizens, drug addicts, children, and the disabled.[54] Clinton vetoed the bill twice, first as part of a budget reconciliation bill, and then as a stand-alone bill passed by Congress after the initial veto.[55] In a statement accompanying his second veto, the President said that, while the bill contained many elements which he supported (such as time limits and work requirements), it also included unacceptable cuts in health care, food stamps, tax credits for the working poor, and benefits for children and immigrants.[56]

The President delivered his second veto on January 6, 1996. Congress took up the question of welfare reform again in May of that year and added provisions to the bill addressing the President's concerns. These changes included the elimination of a proposed cap in annual spending on food stamps and a partial restoration of services for children and the disabled. Nevertheless, the bill still contained substantial cuts in welfare programs, and it retained the provision denying benefits to legal immigrants.[57] It was eventually passed by both houses of Congress with the support of all congressional Republicans and about half of the Democrats.[58]

After weeks of irresolution, the President announced on July 22 that he had decided to sign the bill. In so doing, however, he pursued the unique tack of praising *and* condemning simultaneously the legislation to which he had just put his name: "This act honors my basic principles of real welfare reform. . . . I am proud to have signed this legislation. . . . I am doing so, however, with strong objections to certain provisions."[59] Among the provisions to which the President objected were the cuts to the food stamp program (although the cuts were not as deep as in the original bill) and the denial of provisions to legal immigrants.[60] Nonetheless, he declared that the bill represented "not simply the ending of a system which too often hurts those it is supposed to help, but the beginning of a new era in which welfare will become what it was meant to be: a second chance, not a way of life."[61]

Congressional Quarterly projected that the bill was going to create about $54.6 billion in savings by 2002—a far cry from six billion dollars in *increased* spending that candidate Clinton had advocated in 1992. Senator Moynihan decried the bill's passage, declaring that "this is not welfare reform, but a welfare repeal. It is the first step in dismantling the social contract that has been in place in the United States since at least the 1930s."[62] How was it that a president from Moynihan's own party—the party largely responsible for the creation and growth of social welfare programs in the United States—came to sign a retractive Republican welfare reform bill?

One oft-cited explanation is that of political expediency. His campaign pledge to "end welfare as we know it" had contributed powerfully to the image of Bill Clinton as a "New Democrat," which, in turn, helped him win the White House. He was up for reelection in 1996, and he needed to be able to demonstrate to the public that he was capable of making good on his promise, and so he did. Clinton's signing of the welfare reform bill was regarded by many as the final nail in the coffin of the Dole campaign. In fact, Bob Dole was actually *hoping* for a veto from the President on the very bill which he, as Senate Majority

Leader, had helped to craft.[63] "Bill Clinton's signature on the Republican-drafted welfare-reform bill turned out to be so popular," wrote journalist George Church, "that the President bragged about it over and over to enthusiastic crowds."[64] *The Economist* claimed that, to the extent that the President's decision was to be a defining one, "it is most likely to prove, once and for all, not that he is a New Democrat . . . but that he is what everyone knew him to be all along: a consummate politician."[65]

Nevertheless, it would be difficult to ascribe the President's decision solely to callous political maneuvering. By the time he signed the bill, he was already well ahead of Dole in the polls, and many believe that his signature was not necessary to secure reelection.[66] His decision was surely based at least in part on the fact that he actually *agreed* with much of the substance of the legislation, just as Nixon genuinely approved of many elements of FAP. Clinton had always advocated transforming the system in order to make it incumbent upon able-bodied recipients to find work within a specified period of time. In this respect, the end (and even some of the means) of the bill were not unlike those that the President had always advocated. With the Republicans comfortably ensconced in the majority in Congress, he may have perceived this to be his final opportunity to enact real reform, flawed though it might be. This was the explanation that the President himself offered when he said upon signing the bill that, despite his strong objection to certain provisions, he was doing so, because "the current welfare system is fundamentally broken, and this may be our last best chance to set it straight."[67]

"Just as Daniel Patrick Moynihan had been a gadfly for reform for the Nixon Administration, so was Dick Morris for the Clinton Administration."

Another parallel with the circumstances surrounding FAP is the crucial importance of the President's staff in his decision to sign the bill. Just as Daniel Patrick Moynihan had been a gadfly for reform for the Nixon administration, so was Dick Morris for the Clinton administration. Morris was a political consultant from Connecticut who had first worked for Clinton during his initial gubernatorial campaign. Like Moynihan, Morris was more often associated with the President's opponents than he was with the President. He worked almost exclusively for Republicans, and like Moynihan, he had a keen ability to channel the President's longing for renown into specific policy stances.[68]

He had cautioned the President that the Democrats were going to suffer heavy losses in the midterm elections of 1994, and his prediction turned out to be true. "It was in this fallow stage of his presidency," writes journalist John Hohenberg, "that he decided to experiment with some . . . Republican ideas."[69] Put another way, it was at this stage of his presidency that Clinton turned to Dick Morris. Morris warned the President that he had drifted too far to the left. The liberal consensus that had once dominated the political debate had dissipated, and the President could not govern effectively until he accepted this reality. He encouraged the President to adopt a political strategy called "triangulation": the appropriation and synthesis of the best elements of traditional liberal and conservative thought in order to create a new ideological paradigm. This notion appealed to Clinton, who thought of himself as an innovative and transformational leader. In order for this strategy to succeed, Morris told the President, he was going to have to rethink his approach to welfare, which, he said, had become a loser for Democrats.[70]

He stressed this point to Clinton at every turn. Journalist Bob Woodward writes that Morris was at one point "literally begging him" to sign the Republican welfare reform bill.[71] Senior Presidential Adviser George Stephanopoulos and Deputy Chief of Staff Harold Ickes, two of the most liberal members of the White House staff, took up the mantle of Martin Anderson and Arthur Burns. They became foils for Morris in much the same way that Anderson and Burns had done for Moynihan. Stephanopoulos, writes Woodward, "was going through hell with . . . Dick Morris . . . Clinton obviously trusted Morris's instincts on how to position himself. . . . Previously, instincts had been part of the Stephanopoulos portfolio.[72] Stephanopoulos and Ickes urged the President not to sign the welfare reform bill, arguing that it was bad policy, and that signing it could only enhance his reputation for waffling on controversial issues.[73]

After vetoing the first two versions of the bill, the President put off his decision on the third iteration for months. When it became evident that the bill's passage was imminent—a vote was possible within a number of hours - he convened a meeting of five cabinet secretaries and five key advisers. He gave each one the opportunity to voice his or her opinions on the bill. Secretary of Treasury Robert Rubin, Secretary of Health and Human Services Donna Shalala, and Housing Secretary Henry Cisneros all counseled a

veto, while Secretary of Commerce Mickey Kantor and policy adviser Bruce Reed recommended that he sign it. Shortly after the meeting ended, he told Vice President Gore that he had decided to sign the bill. He formally announced his decision shortly thereafter.[74] Some of the meeting's attendees thought that the President had already made up his mind by the time they were convened, while others were convinced that, despite Morris's admonitions, he had been as yet undecided. Regardless, it seems that at the very least, Morris had a meaningful impact on the President's decision to sign the bill, just as Moynihan had been instrumental in Nixon's decision to support FAP.

Ultimately, it was probably a mixture of the influence of the President's staff, the weight of political considerations, and the impact of Clinton's own policy priorities that led him to sign the bill. The legislation contained enough appealing elements that he was unable to dismiss it out of hand. Additionally, Morris had convinced him that signing it would guarantee him reelection and provide him with an opportunity to move the Democratic Party closer to the political center. As Hohenberg put it, "with the aid of Dick Morris . . . he had brought his party back from the dismal swamp of defeat in the 1994 congressional elections. Could so promising a trend now be abandoned?"[75] Apparently not.

RICHARD NIXON AND BILL CLINTON: CONTRASTING ARCHETYPES OF CONSTRAINED LEADERSHIP

From now on, any comparisons of Bill Clinton and Richard Nixon will almost inevitably begin with the observation that both their presidencies were marred by debilitating political scandals. They have much more in common, however, than this singularly unfortunate distinction. Both men struggled to reconcile their own ideological predisposition with the prevailing views of their time. Both were forced to work with a legislative branch controlled by the opposition party. Both yearned to leave a lasting mark on their nation's history, in the hope that those who record that history might look favorably upon their legacies. In endeavoring to create lasting legacies for themselves, both Clinton and Nixon found that their ability to lead was circumscribed by a set of inalterable parameters. They could not govern without working with a hostile Congress. They could not make decisions without relying on the counsel of advisers who measured their success according to the extent to which they were able to sway the President to their own point of view. And they could not act without first considering political ramifications of their actions—to do otherwise would surely doom their efforts to failure, as was the case with FAP.

Political scientist Stephen Skrowronek has examined the boundaries that constrain all modern Presidents. Hearkening back to Lieberman's discussion of the "structural, political, and ideological obstacles" with which Nixon had to deal, Skrowronek contends that presidential leadership has become stifled by all the "systems and processes" that now represent the interests of those who have a stake in the activities of the federal government. He asserts that these barriers are so imposing as to have brought about "the practical disintegration" of Presidents' authority to govern in the latter part of the twentieth century.[76] If Skrowronek is correct, then we cannot attribute to Presidents Nixon and Clinton a great deal of responsibility for the policies of their administrations. Those policies were, instead, the inevitable result of "systems and processes" over which they had little—if any—control.

In a certain sense, this is true. President Nixon ultimately failed to reform the system, and, for all President Clinton's languished soul-searching, the simple fact of the matter is that the final vote on the Republican bill was decisive enough to override a presidential veto.[77] Moynihan and Morris serve as powerful metaphors for the forces that confined these Presidents. Moynihan was, for Nixon, the voice of the liberal consensus of the day, and Morris was Clinton's anchor to the political center. Moynihan's portrait of Nixon as a "Tory man with liberal policies" and Morris's grandiose talk of ideological triangulation were, once distilled, nothing more than injunctions to embrace boldly the institutional and political boundaries within which the modern presidency must operate. Upon embracing them, a Republican may suddenly find himself fighting for guaranteed annual income, and a Democrat might hear himself heralding proudly the rewriting of the social contract to which his party has staked its legitimacy for over half a century.

Yet, having embarked upon this course, Presidents Clinton and Nixon met with differing degrees of success. In the simplest terms, it was Bill Clinton, not Richard Nixon, who actually signed sweeping welfare reform legislation. Once Nixon's FAP failed, he opted not to pursue further any major welfare legislation, and he directed his staff to "Flush it. Blame it on the budget."[78] But Clinton, having made no progress on his own proposal and having already vetoed two Republican welfare bills, elected to sign the 1996 bill because, he said, it was the country's "last, best hope" for real welfare reform.

Furthermore, it was Clinton, not Nixon, who was able to capitalize politically upon the difficult situation in which he found himself. After the death of FAP, Nixon just blamed "the damn social workers," and resigned himself to failure, reasoning that "politically, I wasn't going to pick up by reason of my support of FAP . . . a substantial number of the liberal democrats."[79] Clinton, however, ever the political animal, was able to turn the systemic weaknesses of his office into a political asset by signing a bill for which he claimed to have only partial responsibility. He took credit for the creditable elements of the bill and disavowed the rest. Having done so, he enhanced his own popularity (thereby improving his chances for reelection) and he furthered the Morris strategy of repositioning his party closer to the middle of the political spectrum. To the extent that the President's victory in 1996 and the Congressional Democrats' surprising success in 1998 can be attributed to the party's having successfully rehabilitated itself, Bill Clinton's decision to sign the welfare reform bill stands as a testament to his political mastery. Unlike Nixon, he recognized his limits and worked within them, endorsing a reform of welfare policy that was far from "cosmetic" and scoring a political victory for himself and his party.

This is not in any way to say that the Personal Responsibility and Work Opportunity Reconciliation Act was necessarily a good thing for the country, or for those to whom the President and Congressional Republicans claimed it would extend a "second chance." It remains to be seen whether the now-falling welfare rolls truly reflect an amelioration in the lives of the nation's poor. Nor is it yet apparent whether the President will be able to keep his promise to soften the impact of the harshest elements of the bill. President Clinton is to be respected for his political prowess; it remains to be seen whether he is likewise to be commended for his policy leadership. In either case, however, he was at least successful in achieving some sort of reform, and in turning the situation to his political advantage. Nixon, meanwhile, deserves credit for the fact that, despite the enormous controversy it generated even within his own administration, he was bold enough to support truly progressive and transformational welfare legislation, largely, it seems, because he simply believed that it was the right thing to do.

The welfare reform policies of the Nixon and Clinton administrations provide us with a number of insights into the distinctive nature of the modern presidency, and into the distinct natures of two modern presidents. Richard Nixon and Bill Clinton faced many of the same institutional and systemic constraints, but they dealt with them in different ways. In many respects, Clinton comes across as the more savvy of the two presidents, and Nixon (perhaps surprisingly) as the more principled. Ultimately, the stories of the Family Assistance Plan and the Personal Responsibility and Work Opportunity Reconciliation Act demonstrate that the presidency is but one cog in the complex policymaking machinery of the federal government. It is for each individual occupant of that office to determine how best to utilize his or her constrained policymaking and political authority. It will be the task of future presidents to take up the mantle of their predecessors and continue the struggle to unlock the full potential of the modern presidency.

LBJ

NOTES

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FROM THE 1920S TO 1990S:

THE CONTINUING CRISES OF CAPITALISM

"And yet . . . it moves."
Galileo, 1633

"The sky is falling . . . the sky is falling!"
Chicken Little

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Galileo forcefully whispered his famous observation after a heated exchange with soldiers of the Spanish Inquisition. The Catholic Church had branded him a heretic for claiming that the sun, and not the Earth, was the center of our solar system. After a fruitless interrogation, in which Galileo's scientific evidence and logic failed to convince the Inquisitors, as he was being hauled away in chains he said, "And yet . . . it moves." In that one statement, Galileo pierced the veil of ideology and revealed the essence of how the world works, regardless of the Catholic Church's official position on the matter.

Recently, the attention of the world has become focused on the global economy and its health in the wake of the onset of the economic "Asian flu" and that phenomenon's effect on emerging markets, and financial markets in the United States.[1] Many experts are now questioning the stability of the global economy and pontificating about ways to prevent future crises or even possible market collapse.[2] Until recently, those who had criticized the global economy and its current structure as unjust and unstable[3] were relegated to the position of "Chicken Littles," who misunderstood the brilliance of the free market and stood in the way of mankind's progress.

Nevertheless, there now seems to be both an acknowledgement, and a good amount of evidence from the financial community, that our global and national economies are unstable, and possibly headed for severe recession, depression, or collapse.[4] Such a collapse, on a global scale, would have profound political, social, and economic consequences. Nations such as India and Pakistan possess the bomb. Nuclear weapons of the former USSR are far from secure.[5] Ethnic and political tensions remain high in patches of Europe, Africa, and the Middle East. Access to eco-

nomic and natural resources remain contentious issues in many parts of the globe. In this type of environment, a world-wide economic financial collapse and depression could have catastrophic consequences. Although such a collapse is far from inevitable, the social and economic conditions, as revealed by history, point towards its possibility.

If one looks at the economic and social conditions prior to the crash of 1929, and the conditions of the last 20 years, one sees some haunting similarities. The pre-crash days of the 1920s were boom times born of Allied victory in World War I, the creation of new technologies, new industries, and production methods that spurred greater economic activity and the search for new markets. The present day economy is a boom time rooted in the "victory" of the Cold War, the introduction of new technologies, industries and production methods brought forth by the computer and high-tech sectors, and the search for new global markets. Both eras are marked by great inequality in income, low union and worker strength compared to capital, overvalued financial markets that outpace the underlying productive economy, and an underlying dilemma of overproduction and inadequate demand.

Both eras can also be characterized as periods when the crude ideology of the omnipotence of free markets dominates the day, within a global political environment that is sorely lacking in leadership. Economist John Gray, a former adviser to the Thatcher government in England, captures this truth, "Unfortunately, in the nineties as well as in the twenties, the defeat of one of the world's great powers has been the occasion of an exhibition of callow dogmatism and hubris."[6]

In the 1920s, political leaders and economists believed that the answer to any downturn in economic performance was to allow the market to fix itself, possibly with some reform to the banking and finance systems, but certainly not with democratic intervention into the sacred marketplace. John Kenneth Galbraith stated this fact quite plainly: "The economic advisors of the day had both the unanimity and the authority to force the leaders of both parties to disavow all available steps to check deflation and depression."[7] Only the desperation and despair of the Great Depression unhinged and made untenable the ideological beliefs in a free-functioning marketplace.

Today, despite some calls for interest rate cuts and a few solitary voices demanding reforms to the world-wide regulation of finance and capital flows, the major leaders and investors continue to place their faith in a global economy ruled by market dominance. Despite the recent crisis, free-market dominated reforms still represent the conventional wisdom.[8] Corporate entities and market financiers make their living off investments and the possession of capital. Thus, both groups are far removed from the medicine necessary to resolve the Asian economic flu and global malaria that threatens the health of our economic and social order. They are like the Spanish Inquisitors during the days of Galileo, blinded by the ideology of society's new god: "the free market," while ignoring history, past experience, and the evidence of social science. The medicine lies not in better market mechanisms or greater fiscal austerity or reform. The true cure lies in history and in returning the economy to a social institution used to ensure social prosperity and stability.

PRODUCTION AND THE CRISES OF CAPITALISM

Over a century ago, Karl Marx identified capitalism as a system full of internal contradictions that he believed would lead to severe economic, political, and social crises and the system's eventual self-destruction.[9] Capitalism's internal tendencies toward monopoly and overcentralization of wealth, and its structural necessities of poverty, inequality, and wage-labor serve to undermine the basis upon which its tremendous growth, productivity and expansion are based.[10] Marx believed that capitalism's tremendous ability to increase production, develop and use new technology, and its need to continually expand to new markets would lead to tremendous overproduction, while its poverty, low wages, monopolization, and inequality would leave inadequate economic or political demand to sustain such production.[11] Hence its eventual crises and collapse.

Since the times of Marx, capitalism has not, as of yet, self-destructed. It has, however, consistently renewed itself in the form of "creative destruction," advancing to levels of new technology and production by overcoming periods of severe crisis.[12] Often this "creative destruction" has had horrendous effects on poor and working people and the value of human life. De-industrialization and plant closings eliminate incomes, strain or destroy families, and virtually wipe out entire towns, with long-term detrimental effects to the social fabric and civic structure, as happened in the Midwestern U.S. in the 1980s.[13] These types of changes allow for the transformation of the economy (i.e. from an industrialized to an information-based economy), but they also undermine the social, economic, and political structure upon which the system is built. Human intervention, usually in the form of state action, has historically been required to save the system and set it on course to a new form.[14] Thus, this "creative destruction" is almost always heavily influ-

enced by government policy (or lack thereof) and the relative power of political and economic actors.

Two of the major forces that have consistently driven capitalism's change have been technology and the need for new markets and new growth. Whether in the 1880s with U.S. Steel, in the 1920s with the development of radio and improvements to auto manufacturing, or in the 1990s with the computer chip and semiconductor, accelerating levels of production, due to increased capital accumulation and improvements in technology, coupled with the need for new markets in which to sell this new production, have driven the evolution of the economy.[15] These forces also drive the system to crisis or possible collapse. Capitalism must therefore evolve and endure these periods where the contradictions of the system and the necessity for new markets under rapidly expanding new technologies and industries must be confronted. The class struggle and the relative level of political power between different sectors of human society ultimately determine who will benefit from such transformations.

"Both eras can be characterized as periods when the crude ideology of the omnipotence of free markets dominates the day, within a global political environment that is sorely lacking in leadership."

In the 1920s, this transformation resulted in American companies facing a lack of demand both at home and within the global economy for their excess production. This lack of demand was due to the productive capacities made possible by new technologies and modes of production, which outpaced the relative demand needed to sustain such production.[16] The production and distribution of goods, capital, and income were extremely concentrated in too few hands.[17] Wages for many working people were falling or stagnant; unions were weak; financial speculators and capital owners were gaining tremendous wealth through the stock market and by overvaluing the returns from the massive production made possible by the new technologies.[18] A steady diet of tight monetary policy and fiscal austerity from the U.S. government further contributed to a lack of income in the hands of consumers and working people.[19] All of these factors exacerbated the problem of over-capacity.

In our current economy, over the past 20 years, a similar phenomenon has been occurring, albeit on a global scale with much wider implications. Like the 1920s, massive overproduction, high inequality, low worker strength due to capital's mobility, a large concentration of capital and wealth in very few hands, and tremendous overvaluation of the stock market, plague the economy.[20] In addition, there is a definite shift of power and politics from control on a national scale by sovereign nations to control on a global scale by corporate entities, large investors, and the most powerful of developed nations. Corporate entities attempt to spread themselves across the globe, searching for higher returns and more markets, constantly attempting to increase production with greater technology while cutting labor costs and ensuring enough diversification to make the resulting effects of over-capacity the problems of their competitors and poor and working communities.[21] Increasing concentration of corporate activity and corporate power is evident in the statistic that at least 40 percent of all global trade in 1997 occurred "intra-firm,"[22] and in the behavior of sovereign nations as they implement policies of fiscal austerity and rigid monetarism at the expense of their working people.

What has resulted are lower wages for working people across the globe, which thereby decreases demand and contributes to over-capacity. The lack of capital and currency controls in the new global economy leaves nations in the lurch, forced to raise interest rates to protect their currencies and attract capital.[23] This rise in interest rates, however, only serves to dampen economic growth (including wage growth) and to increase the transfer of wealth from working people in debt to large creditors.[24] The slower growth and increasing wealth transfer only serve to exacerbate the lack of demand in the global economy, which in turn reinforce a vicious cycle of over-capacity, inadequate demand, and accelerating new production across the globe.

Since no one company is held responsible for the effects that can occur from the dislocations of over-capacity, there is no easy way to stop the process.[25] Everyone tries to continue to expand their market share and their profits and to shift the costs of over-capacity to other competitors, regardless of the economic, social, or political consequences or effects on people in their communities or countries. The hope is that the market will work its magic and make Third World workers into big consumers, but instead extreme instability has arisen amid tremendous growth in global wealth, most of it accruing to corporate interests. As a result, financial markets continue to over-inflate, demand continues to stagnate, inequality deepens, and the global system hurtles toward crisis or collapse economically and politically.

The problem described reflects the contradictions inherent in capitalism that were identified by Marx in the late 1800s. It is capitalism in the throes of creative destruction, in the throes of crisis. What is driving the crisis? The answer is simple, and once again follows from Marx's original thoughts. It is class warfare on a global scale.[26] Specifically, the answer can be found in looking more carefully at the three major characteristics that describe both the last great capitalist crisis in the twenties and our present economy. These three areas are: inequality and the loss of worker power, overproduction and inadequate demand, and overvalued financial markets and the growth of the speculative economy.

INEQUALITY AND LOSS OF WORKER POWER

From 1922 to 1928, gross national income rose from $60 billion to $87 billion: each year GNP rose by an average of about 5 percent, with the index of industrial output reaching its highest point ever in 1929 thanks to more than 60 percent growth in industrial output for the decade.[27] Inflation was almost nonexistent, and official unemployment was extremely low.[28] Per capita income was increasing, and many saw improved living standards.[29] In 1928, Hoover proudly proclaimed that, "We in America today are nearer to the final triumph over poverty than ever before in the history of the land."[30] Nevertheless, the picture was not rosy for everyone.[31]

Many workers labored in poverty. The average annual worker's income lagged behind the earnings necessary for a minimal standard of living, despite the tremendous gains in productivity. Workers in mining, textiles, and farming witnessed stagnation or decreases in their wages and living standards.[32] Chronic, hidden unemployment in areas such as farming, mining, and textiles made life a tremendous struggle for many and served to keep wages low despite a booming economy.[33]

Most discomforting and damaging of all, however, was the growing gap between rich and poor created by the tremendous wealth generated through speculative trade and inflated prospects for new productive capabilities. Stocks in the new technologies and services of the day, such as radio and railroads, were the speculative money-makers.[34] In the 1920s, the number of Americans making more than $500,000 grew by 854 percent and corporate profits reached record levels, while more than 70 percent of Americans made less than the recognized minimal standard of living.[35] According to the Federal Trade Commission, 1 percent of Americans possessed 60 percent of the nation's wealth.[36] Right before the Crash, the top 5 percent of the population received one-third of all personal income.[37]

It is eerie to examine these statistics and sentiments from the 1920s, and then compare these statistics with the present reality. Today a supposedly health economy exists, which according to all the pundits, has eliminated or seriously addressed poverty, unemployment, and inflation, while producing massive amounts of wealth. President Clinton claims that we are enjoying the best economy since the end of World War II. Alan Greenspan, an unabashedly staunch defender of big business and big banking, is seen as the savior of the American economy. Economists and social commentators alike attribute poverty and despair to individual failings, not a marketplace in crisis.

In the last 25 years, a majority of the American work force has seen its wages fall while the real per capita gross domestic product has climbed by a third, with the richest among us pocketing most of the gain.[38] Since 1973, average hourly wages have declined by more than 13 percent (following a 79 percent increase from 1947 to 1973) and real average weekly earnings are down by more than 18 percent, while productivity has increased by 24 percent and executive salaries are up 499 percent.[39] Growth in real family income has been slow, stagnant, or steadily falling for the lowest 80 percent of the American population.[40] The percentage of U.S. families making poverty-level wages has increased from 18.9 percent of the population in 1979 to over 28 percent of the population in 1998.[41] Unemployment, though officially low, remains stubbornly high in disinvested areas and within low-wage sectors of the economy, and is masked by massive underemployment due to low-wage, part-time jobs that do not pay enough to live on, and by structural unemployment.[42] In order to stave off low wages, lack of work, and stagnant livelihoods, 60 million American households have credit card debt, with the average balance at $7,000; as a result, personal bankruptcies hit a record high in 1997.[43]

In terms of inequality, the picture is even bleaker. Currently, the top 1 percent of our nation's households hold about 40 percent of the nation's wealth (having gained 62 percent of all wealth generated in the U.S. over the past six years) and averages $7.8 million a piece in net worth.[44] On average, CEOs now make anywhere from 143 to 812 times as much as the median income of workers.[45] Since 1982, while child poverty has worsened and now stands at over 20 percent, the number of billionaires increased from 13 to 170.[46] Meanwhile, the lowest 90 percent holds only 28 percent of the wealth.[47] The bottom 40 percent has an

average net worth of less than $1000 (in 1995 dollars) and collectively holds less wealth than Bill Gates.[48]

Of course, not all income growth has been reserved for the elite of the elite. The top 20 percent now take home half of the nation's total income yearly, despite the fact that the average working family now works an average of 163 hours more per year today than they did in 1973.[49] In fact, almost 99 percent of the growth of the last six years has been claimed by the top 20 percent of all households.[50] The result, by many measurements, is the largest amount of income, wage, and wealth inequality in the industrialized world and the largest amount in the U.S. since the Great Depression.[51] In fact, the percentage of Americans making over $500,000 per year has been increasing at rates not seen since the 1920s.[52]

Unions continue to decline. Despite renewed organizing efforts and a recent increase in the number of union members, union membership as a share of the U.S. workforce declined yet again last year to just under 14 percent.[53] The Service Employees International Union (SEIU) continues as the only private sector union experiencing large overall growth.[54] In short, wages and income have been stagnant or falling for working Americans. Job security and benefits are extremely uncertain. Poverty is increasing. Unemployment and underemployment are serious problems, and inequality throughout the economy is growing despite great gains in wealth.[55] This reality caused MIT economist Lester Thurow to comment, "Probably no country has ever had as large a shift in the distribution of earnings without having gone through a revolution or losing a major war."[56]

"Like the 1920s, massive overproduction, high inequality, low worker strength due to capital's mobility, a large concentration of capital and wealth in very few hands, and tremendous overvaluation of the stock market, plague the economy."

Globally, the problem is even worse. Labor's share of production income has fallen both in the U.S. and across the globe, while after tax corporate profits have reached record levels and the distribution of wealth and income has reached historically high rates of inequality.[57] Corporate entities and the large financiers to whom they owe their debt are taking back a greater percentage of the benefits of economic activity to the detriment of labor and consumers.[58] As the corporate financiers that bankroll global companies require higher rates of interest to make up for the risks of overproduction, and to satisfy their desire for higher returns, corporations must find ways to squeeze higher profits from labor.[59] These higher interest rates have a negative effect on income distribution as workers who must turn to debt in order to survive transfer greater amounts of their own income to the creditors charging higher interest rates.

This combination of corporate take-backs and the imposition of higher interest rates by global financiers increases inequality across the globe. The net worth of 10 billionaires is now worth 1.5 times the combined national incomes of the 48 poorest countries.[60] Despite all the new wealth created in recent history due to the global economy, 1.3 billion people still live on less than a dollar a day.[61] Even in the wealthiest nations, not only is wage inequality growing, but poverty is spreading as well. According to the UN Development Programme's Human Development Report, the runaway consumption of goods and services across the globe ($24 trillion in 1998) and the expansion of trade and economic activity has not remedied the poor's need for access to basic items, much less a significant income. In the industrialized world alone, at least 37 million people are unemployed, 100 million are homeless, and nearly 200 million have a life expectancy of less than 60 years.[62]

Corporate entities are taking back more from workers and communities, cutting wages and costs to try to enhance profit margins and increase returns to shareholders, and neglecting the necessary investments in workers and communities that would increase productivity and ensure sustained and stable growth.[63] As wages decline and inequality increases in the United States, the number of consumers to absorb the world's excess capacity decreases. The wages being paid in the new developing nations are not high enough to create consumers capable of replacing the U.S. workers that have lost their high-wage jobs. While U.S. workers turn to credit, more work, and a diminished quality of life, workers in the developing world struggle to make ends meet. Owners and creditors continue to capture a bigger share of the economic pie in both locales and the global economy struggles on, suffering from over-capacity and recurrent economic and political dislocations. As a result, workers lose. The system continues to spin out of control in a downward spiral of wages and prices that neglects investments in labor or community. The companies continue to profit, and the global financiers make a killing and gain power in the new global order.

SLACK DEMAND AND OVERPRODUCTION

The loss of worker power and expanding inequality means more than lower incomes for individuals and families. It means less overall demand in the economy and fewer consumers with the purchasing power to buy goods produced. When this lack of purchasing power is coupled with overproduction of goods, a contradiction in the capitalist system and the predominant problem of both the 1920s and the 1990s results: excess supply and inadequate demand. In the 1920s, this problem was illustrated through the auto, steel, coal, and agricultural industries, which produced far more than the American economy or the world economy following WWI could possibly consume.[64] Industry tried to attack this problem of overcapacity and shrinking earnings by cutting costs and lowering wages as the way to increase efficiency and productivity, which only exacerbated the downward spiral of wages and prices.[65] Government tried to address this problem with fiscal austerity, tight monetary policy, and tax cuts for the wealthy.[66] They denied the possibility of any measures to stimulate growth. Keynesian economics was not accepted and certainly not considered to be in the interests of the vast capital owners that were reaping huge amounts of new wealth from the 1920s economy.[67] Their denial ended in the Great Depression.

As observed in *The Progressive,* today "the global system is astride a great fault line: the wondrous new technologies and globalizing strategies are able to produce an abundance of goods, but fail to generate the consumer incomes sufficient to buy them."[68] This can be seen in the perverse reality of booming industries and companies being forced to constantly layoff and restructure their production facilities because of their continual over-capacity.[69] The effects of this overcapacity have been evident with the onset of the Asian flu.[70] But such a reality has been a permanent presence in the global economy for the past six years in the aircraft, auto, and steel industries. More recently, it has been present in the communications, defense, and computer chip and semiconductor industries.[71] These dislocations occur even as corporate entities prosper and they cause social, political, and economic difficulties.

Like the 1920s, companies have engaged in a "low-road" path to economic profit.[72] Corporate entities and owners of capital have responded to the contradictions of the global system by slashing wages and training, relocating to countries and locales that will not impose labor or environmental restrictions, and using diversification, cost cutting, and technology to increase profit.[73] On a policy level, both domestically—and internationally in the form of the IMF—the response to overproduction and slack demand has been fiscal austerity in the form of balanced budgets and the abandonment of spending policies to increase investment and to spur productivity. This fiscal austerity is complemented by tight monetary policy that strangles growth, and regressive economic policies that give breaks to the wealthy and fail to ensure a healthy distribution of incomes throughout society. In short, the current response by business and policy repeats the folly of Hoover and the frivolous 20s, when our reality demands a responsible action to ensure economic stimulation and the redistribution of economic benefits.

OVERVALUED FINANCIAL MARKETS AND THE GROWTH OF THE SPECULATIVE ECONOMY

Overvaluation of the stock and financial markets goes hand in hand with the causes of overproduction in an economy. As technological changes and new methods of production induce companies to produce more and to expand to more markets, the investors providing the capital for such expansion develop overly optimistic expectations of the return. As William Greider notes, "In this atmosphere, investors develop rising expectations of what their invested savings ought to earn and the rising prices in financial markets gradually diverge from the underlying economic reality."[74] Without the necessary buying-power in the hands of consumers and workers, there is no way to ever realize the over-inflated expectations of the investors, and a market correction must eventually occur.

In the 1920s, the overvaluation of the markets amounted to 77 percent of GDP.[75] Hubert H. Hum–phrey, in a historical work on the times, commented that "the shift from industrial capitalism to finance capitalism" revealed the changed emphasis from "legitimate business expansion" to "the exploitation of investors and the consuming public."[76] An unregulated and uncontrolled market boomed beyond the reach of the underlying economy.[77] Investors had overly optimistic expectations in the wake of the technological advances in high growth industries, such as autos, and the productivity gains of the new scientific production processes.[78] As a result, the stock market boomed and created much wealth. With interest rates high and wages relatively low, however, working people did not gain from this wealth, and did not possess the income to sustain its high level of production or the expectations behind that production.[79] With the rest of the globe mired in recession, collapse ensued.[80]

Today, on a national level, the overvaluation has

skyrocketed to 150 percent of GDP.[81] On a global level, the collapse of the Bretton-Woods system has released capital and currency to the vicissitudes of market forces.[82] As a result, wealthy global financiers and investment speculators chase profits in currency speculation and new economic activity across the globe, overvaluing the financial markets and driving up interest rates.[83] Investors become highly optimistic about the prospects for returns based on the new forms of technology and production that are driving corporate activity across the globe. This leads to a separation between the expectations in the financial markets and the underlying productive economy. Greider writes that "According to one estimate by McKinsey & Company, a global consulting firm to multinational banks and businesses, the total stock of financial assets from advanced nations expanded in value by 6 percent a year from 1980 to 1992, more than twice as fast as the underlying economies were growing."[84] McKinsey also estimated that in 1992, the financial assets from OECD countries totaled $35 trillion, double their nation's economic output and 13 times the value of the nations' exports.[85] By the year 2000, McKinsey estimates that the financial assets will reach $53 trillion, triple the size of their economic output and 19 times the value of their exports.[86]

Nevertheless, the problem goes beyond overvalued markets. The free market reforms surrounding currency and capital have left investors chasing greater and greater profits across the globe, demanding a higher premium for capital because of a global economy in which overproduction is occurring at a rapid pace.[87] With overproduction, plants must fail and operations must shut down. Those investors who have supported such operations must take a loss as well; thus they demand a higher interest rate.[88] These interest rates exacerbate the underlying problems of the global economy by handcuffing nations to slow-growth economic policies that contribute to higher unemployment and lower wages, and by serving as a continued income and wealth transfer between debtor nations and debtor people to large, wealthy creditors. As a result, less income is left in the hands of possible consumers, which further dampens the already inadequate demand in the global economy. Massive growth in interest income as a percentage of all U.S. income made in the past 20 years and the growing percentage of debt as a portion of corporate earnings prove this phenomenon to be true.[89] Without a decrease in the price of capital or a tremendous acceleration of economic growth, wealth will continue to be transferred to creditors, financial instability will increase, and a larger number of panics, ruined debtors, financial crises, or a collapse could occur.

"Since 1973, average hourly wages have declined by more than 13 percent (following a 79 percent increase from 1947 to 1973) and real average weekly earnings are down by more than 18 percent, while productivity has increased by 24 percent and executive salaries are up 499 percent."

Similar Eras

The similarities of the 1920s and the 1990s ring true. Both represent historical periods of massive economic, social, and political changes. The 1920s witnessed enormous industrial changes in which the American economy was producing vast amounts of new wealth due to technological advancements and improvements in production. Investment was rampant and extremely overvalued. Wages were low and unions were weak. When this lack of purchasing power in the hands of working people was coupled with the large production of new items and the massive amounts of financial wealth being produced, tremendous economic inequality, massive financial overvaluation, and unmanageable over-capacity resulted. It was a new industrial economy, uncontrolled and working overtime for the interests of the wealthy, on a collision course with social, economic and political disaster.

Today, the global economy and the emergence of the high-tech services and technology sectors have served to produce enormous amounts of new wealth. Like the 1920s, this new wealth and technology have led to tremendous overproduction of goods and extreme overvaluation of the financial markets. Unions are weak, though struggling to come back, and wages have only recently begun to recover after 20 years of stagnation and decline. All of this has resulted in massive inequality of both income and wealth, the most inequality in the U.S. by many measurements, since the 1920s.

In the global economy, the rules that once governed capital flow and trade arrangements have been largely shucked and replaced by the mantra of "free trade" and economic liberalization.[90] Fiscal austerity and tight monetary policy squeeze out attempts to make

the economy grow faster or meet human needs. The only popular "welfare" is "corporate welfare" to ensure that businesses locate in a particular country, state, or locale. The only socialism is the global socialism of bailing out banks and institutions that have collapsed amid the chaos known as global capitalism.

It is an economy that serves Wall Street better than Main Street. It is an economy that produces massive economic and social instability through its perpetuation of overproduction, overvalued stock markets, unregulated capital flows, falling demand, wages and livelihoods, and increasing economic and political inequality between the haves and have nots across the globe.

SOLUTIONS: CREATING A GLOBAL ECONOMY TO SERVE MAIN ST., NOT JUST WALL ST.

Maybe the most disturbing similarity between the 1920s and the present day is the similar political mindset toward the crisis. In the 1920s, despite signs of overproduction and inadequate demand, almost every economic and political leader from economist Joseph Schumpeter to President Herbert Hoover saw any difficulties as a simple market downturn, which could only be fixed by market self-correction.[91] U.S. leadership clung stubbornly to this market obsession until complete collapse and social disorder made it untenable. Massive state intervention and the enactment of government policy to ensure broadly shared prosperity through both the New Deal programs and World War II spending finally served to restructure and revitalize the U.S. economy and usher in our nation's era of greatest economic prosperity.[92]

Today, President Clinton acknowledges that this crisis represents "a stark challenge to economic freedom, which left unaddressed, could stem the rising tide of political liberty as well." [93] Acknowledgements from the financial community include that "fundamental problems—global excess capacity and structural problems remain."[94] Despite these words, there has been little call for reforms that depart from the market-obsessed ideology that sees free-market globalization as the natural progression of mankind.[95] Although some leaders have expressed an interest in regulating global capital to a certain extent, President Clinton and most experts continue to insist on IMF reforms and other banking reform measures that subject nations to the rigors of free market forces. The potential for such reforms to exacerbate the problem of inadequate demand and overproduction continue to be ignored.[96] They are caught in the box of free market ideology. For example, Clinton has stated that he wants nations to have social support systems, but endorses IMF policies that require such support systems to be shredded through fiscal austerity and tight monetary policy that slows growth, especially wage growth.[97] Even critics of the IMF fail to put forth reforms to address inadequate demand, oversupply, capital flows, or the overvaluation and speculative nature of the financial markets.[98] Like the 1920s, the leadership fails to see the true problem of overproduction and lack of demand as a flaw rooted in the failings of the market.

MIT Economist Paul Krugman recently stated, "The problems of the 1990s have distinct similarities with the problems of the 1930s; so do the solutions. We had better all start relearning our Depression economics."[99] Solving the crisis means recognizing and understanding its major cause, not the ideological appearance of the cause.[100] The problem is a lack of demand, which crudely put means that there is not enough money in the hands of working people. The cause of this problem is global class warfare, where capital and the creditor class are continually taking a greater percentage of the wealth created within the global economy, leaving less income in the hands of consumers and workers to buy the products produced. Reversing class warfare on workers requires reasserting control over capital, subordinating the impulses of corporate activity to the fulfillment of human needs, and restoring the economy to an institution that ensures broadly shared prosperity. Although inadequate demand is not the only problem of the global economy, it is the manifestation of the ultimate dilemma: wresting control of the new global economy away from short-sighted corporate/capital interests and restructuring relations to ensure broad and equitable growth in a sustainable manner. The necessary cure or treatment is broadly shared prosperity.[101]

SUSTAINABILITY, REDISTRIBUTION, AND MODERN FORMS OF PRODUCTION

Any policy changes to ensure broadly shared prosperity must deal with the three larger concerns of sustainability, redistribution, and the structural forms of modern corporate capitalism. Any New Deal for the globe must be environmentally-sustainable. Any economic model that aims for broadly-shared prosperity through increased growth and consumption of economic production runs the risk of colliding with environmental limits and wreaking havoc on our natural habitats.[102] It is no secret that modern corporate consumer capitalism has resulted in severe costs to our environment and major damage to the natural

resources that sustain human, plant, and animal life.[103] It is highly questionable whether our current economic system is environmentally sustainable over the long haul if we wish to raise the living standards of all people on the globe.[104] Therefore, any serious policy response to the global crisis must concurrently address environmental/sustainability concerns by challenging our notions about how much and what kind of growth we want our economies to produce. That in turn requires serious consideration of both redistribution and changes to the methods of production inherent in modern consumer capitalism.

For example, the resources necessary to restructure many of the dynamics currently driving the development of the Third World are available. Third World nations want to satisfy basic human needs and obtain economic growth. In order to get the former, they all too often must prostitute themselves to corporate entities in the service of the latter, often at the expense of their poor and working populations, their environment, and their natural resources.[105] This dynamic could be altered by the redistribution of a tiny fraction of the world's income. For example, it would only cost between $5.5 billion and $7.7 billion—the cost of a couple of Stealth bombers—to provide full debt relief for the top twenty debtor nations.[106] It would cost only $40 billion a year for ten years—less than .2 percent of total world income and as much as the U.S. spends on capital gains tax breaks for the wealthy each year (not counting the mortgage interest tax deduction)—to deliver basic social services in all the developing nations.[107] Such investments could pave the way for "human development," not just economic development. They could pave the way for development that is politically, socially, and environmentally sustainable. Redistribution must be entertained.

Beyond redistribution, serious creative efforts to transform the nature, incentives, and ends of modern capitalist production must also be seriously considered. In a world where so many lack decent work and the income to fulfill basic necessities, putting people to work cleaning up and preserving our environment through "green" industries would be a sensible first step to establishing a sustainable world economy. Mark Hertsgaard argues for a "Global Green Deal" where debt relief, environmentally-sensitive technology transfers, and the redirection of $500-$900 billion in environmentally destructive public subsidies ensure sustainable and equitable human development.[108]

Equitable and sustainable changes are inherently antithetical to the current paradigm of highly concentrated corporate power and excessive consumer corporate capitalism. That is why creative changes to the structure of modern capitalism itself must be entertained as well. David Schweigart argues for a market system of "economic democracy" in which employee ownership and self-management, community decision-making in investment, and political democracy are used to create a vibrant, high-growth economy where the competitive and entrepreneurial spirits of capitalism are effectively combined with egalitarian, democratic principles.[109] Under such a model, an economy of broadly shared prosperity and a consumer culture based on "green principles" and "green" industries is more possible and probable.

"When this lack of purchasing power is coupled with overproduction of goods, a contradiction in the capitalist system and the predominant problem of both the 1920s and 1990s results: excess supply and inadequate demand."

Sustainability, redistribution, and structural transformations are key to ensuring the success of any policy prescription to the global economic crisis. The idea is to free nations from global market dependence and to create a framework under which sovereign nations, workers, and communities can assert democratic control over capital to ensure broadly shared prosperity and the fulfillment of human needs. The following five steps are a start toward such an ideal. Although all of the steps are highly interdependent and complementary in use, each has its own merit . The overall goal through the five steps is to ensure lower interest rates, high wage jobs, progressive taxation, strong social safety nets, and effective fiscal spending policies to protect the common good, redistribute income, increase productivity, and spur sustainable and broadly shared growth.

Interest Rates

Interest rates have become the key tool of class warfare in the new global economy. The rates provide a huge wealth transfer to creditors and serve to depress economic growth (for the stated goal of inflation control), thereby keeping the unemployment rate up and the bargaining power of workers down. As a result, economic growth creates tremendous wealth, but fails to substantially raise the wages and incomes of work-

ers. Interest rates must be lowered both here in the U.S. and across the globe. Such a lowering would decrease the transfer of wealth to creditors, increase economic growth towards full employment, and give workers some added strength to bargain for higher wages.[110]

The past 20 years in the U.S. and across the globe show that high interest rates have contributed to economic inequality, historically high levels of unemployment, and thus, inadequate demand.[111] Despite all the hype over recent low unemployment figures, the U.S. record on unemployment is not impressive.[112] In addition, there is a tremendous amount of evidence that our current "low" U.S. unemployment figures are grossly undercounted due to the amount of underemployment in our low-wage labor sectors.[113] Also uncounted are the thousands of permanently displaced workers who have lost their positions to de-industrialization and the corporatization and mechanization of agriculture.[114] A similar unemployment problem exists in Europe, although it is not as bad in comparison to the U.S. as many would claim.[115] In addition, interest rates have served to increase inequality at home and abroad.[116] High interest rates create higher inequality; depress economic growth; increase unemployment; increase the U.S. trade deficit and suck capital from developing nations; and regulate the economy for the investor instead of the wage laborer.[117] To increase demand and re-institute broadly shared prosperity both in the U.S. and abroad, interest rates must be lowered.

Controlling Capital Flows and Global Speculation

In order for a progressive interest rate policy to be fully effective for all nations, and for any measure of a progressive policy agenda to be economically and politically feasible, rules must be re-established for the global economy and capital flows. As Robert Kuttner has recently argued, "completely free global capital movements constrain both the economics and the politics of a social market economy."[118] A global free market in currency and capital movements prevents national governments from following a high-growth, high-employment strategy that spreads the benefits of economic growth and ensures the preservation of the social fabric of communities within the workings of the market.

Furthermore, according to a number of economists, capital and currency markets are not efficient and do not tend toward equilibrium as other markets may, resulting in inefficiency and overvaluation to the real economy.[119] Jeffrey Sachs, professor of international trade at Harvard, has gone so far as to say, "almost all observers now concede that premature liberalization of capital markets (often pushed by the IMF itself) was one cause of the current (economic) crisis."[120]

The Tobin tax on capital transactions, capital controls, and insurance deposits against capital investments, such as those imposed quite successfully in the recent past by Chile, could all be first steps to reining in overliberalized currency and capital markets. In addition, a new global system of currency stabilization and capital controls must be agreed upon in order to limit currency instability, stop speculative runs, and return capital investment and banking to the business of supporting productive investment within policies that advance high-growth, high-employment economies. Currently, many nations cannot lower their interest rates or enact fiscal policies to benefit their people or strengthen their nation's economic or social infrastructure without fear of a major withdrawal of capital or a major challenge to the value of their currency.[121] Only by asserting control over capital flows, currency, and speculative investment can one hope to fully liberate the democratic politics and progressive policies necessary to ensure sustainable, socially-enhancing, broadly-shared growth.

Union Growth and Worker Power

The formation and power of unions must be encouraged and enhanced to ensure that wages keep up with economic growth in both the First and Third Worlds. Without strong unions, capital will continue to take a greater percentage of the world's production income for itself, and corporate power will go unchallenged both in the workplace and on the political battlefield. The organization of workers and consumers must be enhanced to ensure an economy where benefits are broadly shared and growth can be strong and sustained. Interestingly enough, one of the few developing nations where the percentage of production income going to labor has actually increased is South Korea, where the trade union movement is the strongest in Southeast Asia.[122]

Domestic labor law in the U.S. must change to allow for broader, more effective organizing efforts of especially low-wage workers (repealing the Taft-Hartley Act for example). A minimum livable wage must be achieved both in the U.S. and abroad in order to ensure a basic quality of life for all workers and consumers and to provide a strong floor that enhances worker bargaining power. More and more poor and working families in the U.S. depend upon a minimum

wage, but it has lost 30percent of its value since 1970 and fails to allow a family of three or four working full-time to reach the poverty level.[123] Ensuring a wage floor that allows families to meet their basic needs would go a long way to increasing the bargaining power and relative well-being of all workers and consumers across the globe and to ensuring broadly shared prosperity of economic growth. Finally, global agreements on trade and investment that serve to strengthen the power of capital over labor or local governmental control must be restructured. Setting up trade and investment agreements for the new global economy should not mean providing a universal Magna Carta for Capital that frees them from local governmental control and makes property rights supreme to the rights of labor to organize and demand a just wage.[124]

National Spending Policies

Budgets must be enacted on a national level that preserve and provide for the common good and ensure benefits for middle to lower income folks on a universal basis. The past twenty years have seen violent retrenchment in the U.S. and mild retrenchment in Europe in public budgets. The imposition of "Washington Consensus" policies, World Bank Structural Adjustment Programs, and stringent IMF reform measures have extended this pattern of retrenchment to developing nations, forcing those nations to cut budgets, lower taxes, and eliminate social protections in order to become more attractive to global investors.

In the U.S., this budget-cutting has meant that much less of the economy's growth has been directed to public services and public areas (such as schools, public transportation, parks, libraries, income supports, job training and job creation) that benefit the broad population.[125] In addition, significantly fewer dollars (in comparison to other developed nations) have been directed toward infrastructure, research and development, and people-based investments.[126] The results of these short-sighted fiscal policies have been stunted economic growth, retarded productivity, an increasing inability for poor and working people to obtain affordable human needs such as housing, health care, or day care, and an economy that fails to ensure broadly shared prosperity.[127] Today, less than one cent of every federal tax dollar is spent on child care, job training, mass transit, and vocational and adult education combined, while almost 100 times that amount is spent on corporate welfare.[128] This unjust use of our public funds reflects not only bad policy and planning, but a sad commentary on what our society values and how little it cares for the common space that we share as a national community.

This sad reality is repeated in Europe and developing nations around the globe in differing degrees, but with the same bad effects on working people, and on the ability of the economy to ensure adequate demand. The free market ideology claims that nations must balance their budgets. This is a myth; telling a nation to "balance its checkbook" and eliminate all its deficits is tantamount to telling any individual person to never take out a loan for college or a mortgage on a house. It is tantamount to telling us to never invest in our future. We must make the investments that will allow our economies to grow and our societies to flourish on all levels. Not all budget deficits are bad. Deficits allow societies to make investments for the future, increase the productivity of their economies, share the benefits of their growth, and improve the social and public institutions that are the foundation of modern societies.[129] It is sheer ideology to say that all budgets must be balanced, an ideology that serves to direct economic growth toward the wealthy, the investors, and the corporations.[130] We need national budgets dedicated to ensuring full-employment, universal access to basic human needs such as healthcare, income supports, and affordable and decent housing, and to making the necessary investments in education, job-training, infrastructure, technology, and our common spaces that are required for a promising future.

Progressive Taxation

These budgets must be obtained through progressive taxation. The economic and social costs of maintaining high economic inequality are unacceptable and damaging to our future.[131] Nevertheless, economic justice through means of greater production and consumption alone is a recipe for environmental disaster.[132] Redistribution by taxation must play a role; people must realize the need to recycle their income and wealth back through the social infrastructure and society that has made their wealth-creation possible. If the problems of our current economy truly stem from overproduction and inadequate demand, then tax reform must focus not on coddling capital and allowing consumers and workers to hold on to their wealth, but on increasing their purchasing power.

A number of progressive economists and public servants, such as Representative Richard Gephardt, have recently made proposals for a more equitable and simplified U.S. tax code.[133] Under such tax reform,

a number of measures could be undertaken. The corporate tax rate, which has decreased significantly in the past thirty years, could be returned to levels closer to post WWII levels. The Earned Income Credit could be further expanded to reach more of our struggling working poor. The regressive cap on Social Security and Medicare payroll taxes could be lifted. Developing a federal income tax structure with higher marginal rates, a higher tax burden for wealthier groups, and fewer exemptions and tax brackets would serve to simplify the tax code, spread the benefits of a growing economy, and ensure that public revenue streams keep better pace with economic prosperity.[134] Inequality and the need for adequate demand and sustained and equitable economic growth cannot be seriously addressed without such taxation.

GLOBAL COOPERATION

Finally, all of this must be achieved with a new level of global cooperation. The defining feature of the global economy is that it provides new avenues for capital to escape social responsibility at the hands of individual nations. This phenomenon of capital flight and the resulting national impotence against corporate power can be overestimated, and can become a self-fulfilling prophecy that scares nations into ceding precious ground too easily and backing off of all progressive measures.[135] While it is true that corporations have more power to move and avoid social responsibilities, they cannot move in every situation, and often have many reasons to stay in a certain location beyond labor costs.[136] Nevertheless, it must be acknowledged that the threat of corporate flight provides another weapon in the corporate arsenal that must be candidly confronted. This requires cooperation on the global level. If we can cooperate for the purposes of military action and free-trade agreements, then we can cooperate for the health of our economies and our democratic way of life. Granted, it would be foolish not to recognize the different political interests behind cooperating on the former as opposed to the latter, but it serves to illustrate that the problem is not economic, it is political.

Restoring broadly shared prosperity is good policy. Many would say that such a policy agenda would lead to disaster. The proponents of the Washington Consensus (a large majority of the mainstream neoliberal economists) would claim that these policy solutions would lead to high inflation; stagnation of economic activity due to higher taxes, wages, and regulation; lower productivity growth; and fewer business start-ups.[137] They would continue to call for a neo-liberal recipe of fiscal prudence, relatively higher interest rates to control inflation, flexible labor and social protections to ensure efficient uses and movements of capital, and lower taxes and regulations. All this in the name of freeing up the market to work its wonders and spread the opulence and benefits of modern consumer capitalism to all corners of the globe. But such recipes fly in the face of both recent and historical experiences. They are products of a blind ideological adherence to the free market. Such a recipe is a recipe for disaster.

Theoretically and practically, there is no reason why a democratically-enhanced, high-wage, high-productivity path to development focused on meeting human needs first cannot be pursued. Such a path could be paved by a global system of capital controls, a global commitment to debt relief, and a global Marshall Plan to ensure basic social services in all countries. There is plenty of evidence to show that a "high road to economic development" is not only possible, but beneficial in a number of ways.[138] More importantly, it is not only possible, it is imperative if we are to address the crises that we face. The problem of implementing the solution is not one of economic possibility or good policy, it is one of pure power and politics.

PROSPECTS FOR CHANGE

The prospects for change are not rosy. Although there is a general acknowledgement of a crisis, as is evidenced by numerous statements from President Clinton and English Prime Minister Tony Blair, those powers calling for reform are inherently incapable of realizing the correct medicine for the global economic flu.[139] Remedying the crisis at its root is not in the general interest of those leaders or the powers to which they answer. Curing the ill-health of the global economy requires challenging the global class warfare by corporate interests and the "rentiers' regime" of investors and speculators that results in expanding inequality and slack demand due to the lack of economic wealth shared with consumers and workers.[140] This will require greater controls on capital, social and economic responsibility from corporations, higher wages for working people across the globe, lower interest rates and thereby lower returns to investors and creditors, and a redistribution in wealth and power to regular people. It requires reigning in free capital, which is an economic and ideological threat to wealthy interests. It requires a progressive global economic policy dedicated to meeting human needs within the market economy. Put simply, this is an

agenda that is diametrically opposed to the desires of large capital and corporate wealth.

Nevertheless, there is a glint of hope. The hope lies in the power of people exercising their democratic rights through their sovereign communities and nations. Recent events in Europe give hope that political change may be occurring and that cooperation may be possible to ensure a global economy that serves human needs as well as profit needs. Europe, for the first time in its history, on the cusp of unification and during a time of neo-liberal policies of the global economic policies, has leftist or left of center governments in its four major countries (Germany, France, England, and Italy). Such a historic turn of events is no coincidence. It is a democratic expression of the will to stop the unregulated and uncontrolled march of market forces across the globe that are destroying communities, neglecting human need, and threatening to destroy a way of life in Europe that has protected the common good from the vicissitudes of the market. All four have given at least lip service to the need for European cooperation over issues of job creation, unemployment, social welfare policies, tax policies, and the environment.[141] Hints of cooperation have been voiced over the issue of imposing capital controls and creating a systematic way to control capital flows across Europe towards the end of once again re-establishing global rules on currency and capital.[142]

Whether or not cooperation will occur to comprehensively deal with the crisis is a political question. If class warfare continues unabated and economic policy is drafted to serve only the short-term interests of corporate conglomerates, investors, and capital, then the previous suggestions as a whole are sheer fantasy. Political hope lies with the power of vigorous protest, a vision of development for all humanity, and democratic organizing and dissent. Democratic reaction could cause some of the actors in the corporate world to recognize their interest in preserving some level of democratic control over capital and social stability (not unlike the realization made at the time of the New Deal), providing hope for some parts of such an agenda.

Conclusion

"And Yet, . . . Still, It Moves."
Frederick Douglas

Nearly 200 years after Galileo rejected the ideology of the Catholic faith, Frederick Douglas used the same words to reject the ideology of white supremacy. Douglas argued that the racial caste system in the U.S. was based on ignorance, cancerous to a democratic society, and an immoral tool of power and oppression. When mainstream politicians and white supremacists alike refused to see beyond their ideological blinders, Douglas symbolically repeated the words of Galileo. Today, we must be willing to move; we must have the same courage as Galileo and Douglas. We must reject the ideology of corporate global capitalism: a viewpoint that ignores history, threatens the stability of our globe, and justifies the exclusion of a large segment of our human family from the right to live fully human lives free of economic, political, and social oppression.

Our global system is in crisis. Whether it ends in complete collapse or depression is not the point. The point is that our current social and economic reality parallels in a very negative way the social and economic reality of the 1920s. It is important that we recognize this truth and pierce the ideology of those who benefit from a policy agenda of global class warfare that threatens the long-term stability of our economy, the quality of human development, the political viability of genuine democracy, and the environmental sustainability of our planet. Our current reality, when placed in context and comparison to the 1920s, should give us normative, economic, and political reasons to pause, and hopefully, act.

The financial community has recognized the dilemma, but they are incapable of answers because of their interests. Traditional notions of class struggle and the inherent contradictions of capitalism explain the current global economic crisis. Therefore, the solution lies in democratic action and in the stakeholders of the status quo recognizing that their future and present interests are tied to the broad prosperity of the global community on an economic, social, political, and environmental level. Without this self-realization, or a political or social movement to force that realization, we are doomed to dire consequences, especially for poor and working people and possibly for our society as a whole.

Notes

1. Craig Hines, "APEC Conference Targets Asian Crisis," *Houston Chronicle* (November 15, 1998), pp. 1A, 21A.
2. Please see: The September 14th cover of *Business Week* that declares: "Global Crisis: Time to Act" and that declares within in an editorial by one of *Business Week's* own editors, "The peace and prosperity of the world are at stake." in "Bottoms Up," *The Progressive* (November 1998), pp. 8-9.; Also see: Paul Krugman, "The Return of Depression Economics," *Foreign Affairs,* vol. 78, no. 1 (January/February 1999), pp. 56-59; George Soros, *The Crisis of Global Capitalism: Open Society Endangered* (New

York: Public Affairs, 1999); William Greider, *One World, Ready or Not: The Manic Logic of Global Capitalism* (New York: Simon & Schuster, 1997); John Gray, "Not for the First Time: World Sours on Free Markets," *The Nation* (October 19, 1998), pp. 17-18; "Will China Be Next?" *The Economist* (October 24, 1998), pp. 17-18; Bill Fleckenstein, "Can It Happen Again?: Stock Market Special Report" (April 1998).

3. Individuals such as William Greider, Gerry Mander, Edward Goldsmith, Ralph Nader, David Korten, Vandana Shiva, Jeremy Rifkin, and many others have long criticized the global economy as both unjust and inherently unstable. Please see: Jerry Mander and Edward Goldsmith, eds., *The Case Against the Global Economy: And For a Turn Toward the Local* (San Francisco, CA: Sierra Club Books, 1996). In addition, recent economists have questioned its effects, if not its entire existence. See: "An Interview with Dani Rodrik: Has Globalization Gone Too Far?" *Challenge*: *The Magazine of Economic Affairs*, vol. 41, no. 2 (March-April 1998), pp. 81-94.

4. "'About 40% of the world economy is either in or heading into a recession,' said Nariman Behravesh, Chief international economist at Standard and Poor's DRI in Lexington, Mass." See: "Global Finanical Turmoil Will Drag Down U.S., World Economies, President Says" *Austin American-Statesman* (October 3, 1998), pp. G1, G2; Cragg Hines, "APEC Conference Targets Asian Crisis," *Houston Chronicle* (November 15, 1998), pp. 1A, 21A.; "GDP Growth Slows to 1.8%," *Austin American Statesman*, (September 28, 1998), p. D1; "U.S. Job Growth Hit By Slump," *Austin American-Statesman* (October 3, 1998), p. D1.

5. Erin Middlewood, "Nunn-Lugar Program is Real 'Peacemaker'," *The Progressive* (October 6, 1997). Available Online: http://www.progressive.org/mp.html. Accessed: 3-23-99.

6. Gray, "Not for the First Time," *The Nation*, pp. 17-18.

7. "Bottoms Up," *The Progressive* (November 1998), pp. 8-9.

8. The Washington Consensus is the neo-liberal economic philosophy currently holding sway within the major industrialized nations, the global financial institutions (IMF and World Bank), and with corporate investors, unless of course they must deviate from it to obtain corporate welfare or subsidies of some sort. Fiscal austerity, no budget deficits, tight monetary policy with high interest rates to control inflation, privatization, low taxes and regulation, etc., are at the heart of its philosophy of freeing the market to work its magic. It's had catastrophic effects for poor and working people across the globe and has arguably heavily contributed to the current crisis. Moises Naim, "Latin America the Morning After," *Foreign Affairs*, vol.74, no.4 (July/August 1995), p. 4; Asad Ismi, "Plunder with a Human Face," *Z Magazine* (February 1998), pp. 9-12; Craig Hines, "Dispute erupts over IMF's Role in Asia's Economic Collapse," *Houston Chronicle* (November 15, 1998), p. 23A.

9. David McClellan, ed., *Karl Marx: Selected Writings* (New York: Oxford University Press, 1977), pp. 226, 364, 389, 485-487, 491.

10. Ibid.

11. Ibid.

12. Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper Torchbooks, 1962), p. 83.

13. Please see: David Bensman and Roberta Lynch, *Rusted Dreams: Hard Times in a Steel Community* (McGraw-Hill Book Company, 1987).

14. The idea that capitalism suffers from internal contradictions that produce "crises" that will lead to its ultimate "destruction" is of course from Marx. However, we also know from history that capitalism has survived many different periods of crisis by political and state intervention. This is revealed in the form of anti-trust laws that are required to break capitalism's own internal tendency to monopoly ownership and over-centralization of capital in too few hands, social welfare legislation that is required to deal with the structural realties of poverty, unemployment, inequality, and market failures that threaten the social and political stability of capitalist economies, and massive, Keynesian state spending that is required to spur continued market growth and ensure adequate demand.

15. Howard Zinn, *A People's History of the United States* (New York: The New Press, 1997), pp. 219-223, 263-266, 277-282; Howard Zinn, *The Zinn Reader: Writings on Disobedience and Democracy* (New York: Seven Stories Press, 1997), pp. 168-171; Greider, *One World, Ready or Not*, 1995.

16. Please see: Roger Biles, *A New Deal For the American People* (DeKalb, IL: Northern Illinois University Press, 1991), pp. 5-19; Frances Fox Piven and Richard A. Cloward, *Poor People's Movements: Why They Succeed; How They Fail* (New York: Vintage Books, 1977), p. 45; John Kenneth Galbraith, *The Age of Uncertainty: A History of Economic Ideas and Their Consequences* (Boston: Houghton Mifflin Co., 1977), p. 208; Donald L. Bartlett and James B. Steele, *America: What Went Wrong* (Kansas City, MO: Andrews and McMeel, 1992), p. 4; Hubert H. Humphrey, *The Political Philosophy of the New Deal* (Baton Rouge, LA: Louisiana State University Press. 1970), p. 9; Howard Zinn, *A People's History of the United States* (New York: The New Press, 1997), pp.219-223, 263-266, 277-282; Howard Zinn, *The Zinn Reader: Writings on Disobedience and Democracy* (New York: Seven Stories Press, 1997), pp. 168-171; Greider, *One World, Ready or Not*, p. 104.

17. Ibid.

18. Ibid.

19. Ibid.

20. Please see: Greider, *One World, Ready or Not*, pp. 48-49,

221; Lawrence Mishel, Jared Bernstein, and John Schmitt, *The State of Working America 1998-99,* Economic Policy Institute, (New York: Cornell University Press, 1999), pp. 5-7, 8-9; James Galbraith, *Created Unequal: The Crisis in American Pay* (New York: The Free Press, 1998), pp. 3-22; Lawrence Mishel, "Rising Tides, Sinking Wages," *The American Prospect* no. 23 (Fall 1995), pp. 60-64; Lawrence Mishel, "Behind the Numbers: Capital's Gain," *The American Prospect* no. 33 (July-August 1997), pp. 71-73.

21. Greider, *One World, Ready or Not,* p. 104.
22. Ibid., p. 137.
23. Robert Kuttner, "Constraining Capital, Liberating Politics," *The American Prospect,* no. 40 (September-October 1998), pp. 6-9.
24. Please see: Galbraith, *Created Unequal.*
25. Greider, *One World, Ready or Not,* p. 103.
26. The class antagonisms inherent in capitalism drive the system to crisis. By denying just compensation to workers and consumers, the capitalist system, in both an economic and political sense, undermines the bases of its reproduction: namely more wage-labor (which is necessary to create more capital) and more markets in which there are sufficient consumers with the necessary buying power to consume production. McClellan, ed. *Selected Writings,* pp. 222-231, 477-483.
27. Biles, *New Deal,* p. 10; Piven and Cloward, *Poor People's Movements,* p. 45; Galbraith, *A History of Economic Ideas,* p. 208.
28. Zinn, *Zinn Reader,* p. 168.
29. Biles, *New Deal,* p. 10.
30. Ibid., p. 17.
31. See: Zinn, *Zinn Reader,* pp. 168-171; Piven and Cloward, *Poor People's Movements,* p.48
32. Biles, *New Deal*.
33. Galbraith, *Age of Uncertainty,* pp. 208-211.
34. Ibid.
35. Ibid.; Donald L. Bartlett and James B. Steele, *America: What Went Wrong* (Kansas City, MO: Andrews and McMeel, 1992), p. 4.
36. Biles, *New Deal,* p. 10.
37. Zinn, *People's History,* p. 281.
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72. Gordon, *Fat and Mean*, pp. 144-171.
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76. Humphrey, *Political Philosophy of New Deal*, p. 9.
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78. Zinn, *A People's History of the United States*, pp. 219-223, 263-66, 277-282; Howard Zinn, *The Zinn Reader: Writings on Disobedience and Democracy*, pp. 168-171; Greider, *One World, Ready or Not*.
79. Ibid.
80. Ibid.
81. Cited in Lance Lewis, "Return of the Big Bad Bear?" as cited in *Barron's*, July 6, 1998.
82. Greider, *One World, Ready or Not*, pp. 48-49.
83. Ibid., pp. 228-258.
84. Ibid., p. 233.
85. Ibid., p. 234.
86. Ibid., p. 234.
87. Ibid., pp. 103-37; Kuttner, "Constraining Capital, Liberating Politics," pp. 6-9.
88. Unlike the conventional wisdom that says that higher interest rates in the global economy are caused by scarcity of capital, the real story is that there is not a lack of credit, but a lack of good debtors. There is greater risk to go along with greater returns in the global economy. In addition, due to free market reforms, creditors have the ability to bid up the price of capital. Finally, thanks to the lack of currency regulation, creditors are able to force nations to increase interest rates in order to protect their currencies. Please see Greider, *One World, Ready or Not*, p. 235.

89. According to James Galbraith, interest income as a percent of all personal income in the U.S. has risen from about 3 percent in the 1950s to between 13-14 percent in the 1990s largely benefitting the top 10 percent of the U.S. economy which the rest of society's wages stagnant and fall behind. Please see James K. Galbraith, *Created Unequal: The Crisis in American Pay*, p. 82; According to Dean Baker, "Corporate profits were 34 percent of corporate debt in 1960; by 1990, profits were only 15 percent of debt," illustrating corporate need to squeeze wages in order to maintain high profits and pay off their growing debts, cited in Greider, *One World, Ready or Not* p. 183.
90. Of course, even under today's terms of "free trade," there is a tremendous amount of intervention into the marketplace. It is probably most accurate to say that the notion of a completely "free" market is a myth. It is more accurate to view the question from the standpoint of "On whose behalf and for whose interests is the intervention that is occurring taking place?"
91. John Kenneth Galbraith, *The Age of Uncertainty: A History of Economic Ideas and Their Consequences*, p. 208.
92. It is fairly well-accepted by economists and scholars on both sides of the political spectrum that some combination of New Deal programs, WWII spending, and post-WWII spending, all of which were massive state interventions into the marketplace, was responsible for a more robust, more broadly-shared American economy.
93. Craig Hines, "APEC Conference targets Asian crisis," *Houston Chronicle* (November 15, 1998), pp. 1A, 21A; Craig Hines, "Dispute erupts over IMF's role in Asia's economic collapse," *Houston Chronicle* (November 15, 1998), p. 23A.
94. Ibid.
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96. "Bottoms Up," *The Progressive*, pp. 8-9.
97. Ibid.
98. Hines, "Dispute erupts," *Houston Chronicle*, p. 23A.
99. Paul Krugman, "The Return of Depression Economics," *Foreign Affairs* vol. 78, no. 1 (January/February 1999), p. 58.
100. This is once again a nod to Marx and his discussion of the role of ideology in hiding the true essence of the social relations of production. Karl Marx and Frederick Engels, *The German Ideology, Part One* C.J. Arthur, ed. (New York: International Publishers, 1989), pp. 57-72; McClellan, ed. Karl Marx: *Selected Writings*, pp. 389, 505.
101. The real solution to the American trade deficit can only be found in ensuring broadly shared prosperity across the globe so that we are not the buyer of last resort for a global economy based on the highly unconvincing notion that all can get rich by exporting without raising the wages of workers and consumers.
102. For a number of articles documenting and presenting the evidence of the disastrous effects of corporate global capitalism on the environment, please see: Mander and Goldsmith, eds., *Case Against Global Economy*, 1996; "How Corporations Threaten the Earth," *Special Issue: Dollars and Sense* no. 218 (July/August 1998); Mark Hertsgaard, "A Global Green Deal," *The Nation* (February 1, 1999), pp. 18-21.
103. Ibid.
104. Ibid.
105. Martin Khor, "Global Economy and the Third World," in Mander and Goldsmith, eds., *Case Against Global Economy*, pp. 47-59.
106. "In Fact . . . Doing the Numbers," *The Nation* (July 14, 1997), p. 7.
107. Ibid.; Mark Zepezauer and Arthur Naiman, *Take the Rich Off Welfare*. (Tuscon, AZ: The Real Stories Series. Odonian Press, 1996), p. 41.
108. Mark Hertsgaard, "A Global Green Deal," pp. 18-21.
109. David Schweickart, *Against Capitalism* (Boulder, CO: Westview Press, 1996), pp. 60-77.
110. Galbraith, *Created Unequal*, 1998.
111. Ibid.
112. Ibid., pp. 75-76.
113. Please see: Lester Thurow, "The Crusade That's Killing Prosperity," pp. 54-59; Jeff Faux, "The American Model Exposed," p. 18; Phillip Harvey, "Paying for Full Employment: A Hard-Nosed Look at Finances," *Social Policy* (Spring 1995), pp. 21-30; Ward Morehouse, "The Multilateral Agreement on Investment: An International Human Rights Crisis," *Guild Practitioner: National Lawyers' Guild*, pp. 12-16; Labor Research Association, "Real Unemployment," *Economic Notes*, p. 2.
114. Ibid.
115. Faux, "American Model," *Nation*, p. 17-19.
116. Galbraith, *Created Unequal*, 1998.
117. Ibid.
118. Robert Kuttner. "Constraining Capital, Liberating Politics," no. 40, pp. 6-9.
119. Please see recent work or statements by: Jagdish Bhagwati, former chief economic adviser to GATT, Jeffery Sachs, Barry Eichengreen, Joseph Stiglitz, and Lester Thurow; "Bottoms Up," *The Progressive* (November 1998), pp. 8-9; Robert Kuttner, "Constraining Capital, Liberating Politics," *The American Prospect*, no. 40 (September-October 1998), pp. 6-9; Lester Thurow, *The Future of Capitalism*, (New York: William Morrow and Company, Inc, 1996), pp. 211-233.
120. "Bottoms Up," *The Progressive*, pp. 8-9.
121. Kuttner, "Constraining Capital, Liberating Politics," pp. 6-9.
122. Gredier, *One World, Ready or Not*, p. 75.
123. Richard Rothstein, "Minimum Wage Debates," (May 22, 1996), pp. 1-4. Available Online: http://epn.org/

rothstei/ro960709.html. Accessed: 6-10-98; Mishel, Berstein, and Schmitt, *State of Working America,* p. 191; John Hitzfelder, "Skyrocketing Rent Spurs Living Wage Campaign," *The Working Stiff Journal,* vol. 1, no. 1 (September 1998), pp. 1-2. "Work Ethic and Reward," *Austin American-Statesman,* (October 7, 1998), p. A12.

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Size Matters:

Measuring Income Inequality Across U.S. Cities

by Daniel B. Gubits

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Many different measures are used to gauge the economic and social health of America's cities. Unemployment rates, median property values, and sales tax collections measure the strength of local economies. Population growth and employment figures in different industries paint a picture of how regions are changing demographically and economically. Poverty, infant mortality, and malnutrition rates inform us about those residents in most need of assistance. One measure that is infrequently applied to cities, however, is that of income inequality; that is, measuring the gap between rich and poor. (For a more detailed explanation of inequality, see "Inequality 101.") Over the past decade, many social scientists have become increasingly concerned with income inequality within the United States, as well as across the globe. Though the economy is performing strongly, the gap between lower income households and upper income households is growing. This national trend is reflected at the city level, which makes income inequality a useful metric in understanding the socio-economic conditions of cities. Scholars have conducted a modest amount of research on urban income inequality and have found several factors

that are associated with inequality. Those factors, and the implications of inequality, as studied through an examination of income inequality in U.S. metropolitan areas, provide a useful policy tool for understanding the extent to which increasing income stratification is occurring, or whether all groups are benefiting equally, from economic growth within metropolitan areas.

Why Inequality is Important

The topic of income inequality in the United States has captured increased interest in the past few years as it has become clearer that the economic expansions of the 1980s and 1990s have not benefited equally all segments of the population. In 1980, the top fifth of American households took home 44.1 percent of all income, and the bottom fifth took home just 4.2 percent. By 1994, the top fifth had captured 49.1 percent of all income and the share of the bottom fifth had fallen to 3.6 percent. Over this same period, the share of the top 5 percent of households had risen from 16.5 percent to 21.2 percent of all income.[1] When citizens have such drastically diverging fortunes, the result can be social and political fracturing. Ultimately, inequality endangers our ability to think of ourselves as one nation and one people. James Galbraith writes,

> With high inequality, of income and of wealth, it becomes easy to know whether one is likely in the long run to be a net gainer, or a net loser, from public programs of family assistance, pension security, and health care. . . . High inequality therefore weakens the willingness to share at the same time that it concentrates resources in the hands least inclined to be willing. In this way . . . inequality *threatens the ability of society as a whole to provide for the weak, the ill, and the old*.[2] (emphasis added)

The implications of income inequality within a metropolitan area are similar to the effects of national inequality and perhaps more startling to behold. It is in cities that inequality is most distinct—that is, where rich neighborhoods exist right next to poor ones. As at the national level, a widening income gap within a metropolitan area can translate into lower support for programs to help the poor and working poor; this may mean opposition to projects such as affordable housing and homeless shelters. Public schools could become weaker when the broad support of the community is eroded by increasing private school attendance. The push for school vouchers is perhaps evidence of the weakening support for the public school system.

Table 1 lists thirty U.S. metropolitan areas in ascending order of inequality, as determined by each city's respective Gini coefficients in 1990. The Gini is a useful statistic to gauge wage inequality in a non-normative manner. (For a technical explanation of Gini coefficients please refer to "Calculating Gini Coefficients.") The rankings of the metropolitan areas show that generally, "newer," fast-growing cities such as Salt Lake City, San Jose, Seattle, Orlando, and Portland, have Gini coefficients that are relatively smaller in magnitude. "Older" cities in the industrial North, such as New York, Pittsburgh, Chicago, Cleveland, and Detroit, tend to have Gini coefficients that are relatively larger in magnitude. The comparisons of Gini coefficients reveal that income inequality tends to be greater in the older cities in comparison with newer cities. By no means does this pattern hold true for all cities, however, as Minneapolis and Milwaukee have relatively smaller Gini coefficients, while Austin and Tucson have relatively larger Gini coefficients.

The ranking presented in Table 1 raises the following question: What causes cities to have different levels of inequality? A linear relationship between city size and level of income inequality seems to be an obvious candidate, since the largest city, New York, has the highest level of inequality. A closer look at the table, however, reveals that some cities of similar size have widely divergent Gini coefficients. For example, medium-sized cities do not cluster at either the high or low end of the rankings. Nevertheless, all the cities with over 1 million households, except for Seattle, rank in the lower half of the table. Why would larger cities have greater levels of income inequality? Several economists have offered theories about what urban size might have to do with income inequality.

Theories of Urban Inequality

The most debated issue within the small body of literature on urban income inequality is, in fact, the relationship between city size and inequality. Do large cities have more inequality than small cities, or vice versa? Economist Simon Kuznets developed a theory in 1955 about how economic growth and income inequality are related within nations. Kuznets' "inverted U hypothesis" holds that initial economic growth brings an increase in inequality, while further growth is accompanied by a decline in inequality. In the beginning stages of economic growth, inequality worsens as increasing population growth hurts the poor, and early industrialization leads to burgeoning

Table 1

Metropolitan Areas, Ranked by Gini Coefficient

City	Gini	Median income	Households
Salt Lake City MSA	0.358	$30,882	347,121
Washington, DC MSA	0.361	$46,884	460,785
San Jose, CA PMSA	0.363	$48,115	522,040
Minneapolis-St. Paul MSA	0.366	$36,565	935,760
Seattle CMSA	0.369	$35,047	1,003,337
Lincoln, NE MSA	0.371	$28,909	82,836
Springfield, IL MSA	0.373	$30,299	76,163
Orlando, FL MSA	0.375	$31,230	402,519
Milwaukee PMSA	0.375	$32,316	538,179
Sacramento MSA	0.377	$32,734	557,811
Raleigh-Durham MSA	0.378	$33,290	287,835
Portland, OR CMSA	0.378	$1,071	576,083
Denver CMSA	0.380	$33,126	739,001
Columbus, OH MSA	0.381	$30,668	525,558
Atlanta MSA	0.385	$36,051	1,056,929
St. Louis MSA	0.386	$31,774	923,639
Boston CMSA	0.389	$40,666	1,545,347
Detroit CMSA	0.395	$34,729	1,724,76
Cleveland CMSA	0.396	$30,332	1,058,648
Chicago CMSA	0.397	$35,918	2,903,236
Tulsa, OK MSA	0.402	$26,991	277,423
Cleveland PMSA	0.402	$30,560	712,647
San Antonio MSA	0.403	$26,092	451,731
Tucson, AZ MSA	0.405	$25,401	262,129
Austin MSA	0.406	$28,474	303,921
Los Angeles CMSA	0.407	$36,711	4,909,218
Pittsburgh CMSA	0.408	$26,501	891,071
Houston CMSA	0.409	$31,488	1,333,707
Jackson, MS MSA	0.417	$26,365	139,571
New York CMSA	0.427	$38,445	6,617,074

Source: U.S. Bureau of the Census, *Census of Population and Housing, 1990, Metropolitan Areas, Social and Economic Characteristics,* Table 37 (Washington, D.C., November 1992).

Note: Gini calculations by author.

wealth for only a small minority of the population. In later stages of growth, social and economic institutions come into being that improve the status of low-income groups, and capitalist wealth grows at a slower rate, leading to a decline in inequality.[3]

Researcher Norman Cloutier, however, discusses an alternative application of Kuznets' theory, in which the inverted U-shaped relationship is flipped "right side up." In this version, manufacturing initially brings rising average incomes and a lowering of inequality. Later, the decline of manufacturing and the rise of the service sector brings about a greater differentiation of workers by skill level and, hence, an increase in inequality.[4] Figure 1 illustrates both Kuznets' and Cloutier's hypotheses.

Economists Garofalo and Fogarty use the concept of amenities compensation to provide an alternate rationale for a "right side up" U-shaped relationship. The initial expansion of a city brings an increase in the amenities of the city. Amenities attract skilled workers, increasing their supply, and lowering their relative wages. As the city continues to grow, negative externalities such as pollution and traffic are produced, which cause the relative compensation of skilled workers to rise, increasing income inequality.[5]

While Kuznet's inverted U hypothesis was created to describe inequality changes within countries, there is some evidence that it holds true for cities as well.[6] In general, empirical studies of metropolitan areas have focused on determining the specific factors that influence income inequality, rather than attempting to prove or disprove a more complex theory such as the

INEQUALITY 101

Income inequality is more complex concept than most measures of poverty, because it provides information about the entire distribution of income. At the heart of the concept of income inequality is the Lorenz curve, which is a graphic representation of the income distribution.

A simple example will help shed light on how the Lorenz curve works. Imagine a country with 100 people who have $100,000 in total income. If each person received $1,000 in income, the Lorenz curve would be straight and the country would have complete income equality, as exemplified by the straight line in Figure 1. If 99 people received $0 in income and the 100th person received all $100,000 then the country would have complete income *inequality*.

Income inequality is often discussed in terms of quintiles. Consider the example of the country with 100 people, and assume that each person has a different level of income. Then line them up in ascending order. The first 20 people are the first (or bottom) quintile, the second 20 people are the second quintile, and the last 20 people (those with the highest incomes) are the fifth (or top) quintile. The second quintile will have a larger piece of the total $100,000 than the first quintile, the third quintile will have a larger piece than the second quintile, and so on. In a perfectly equal world, each quintile will have 20% of the total income, as exemplified in Table 1. In an unequal world, each quintile will have more than the quintile below it, and less than the quintile above it, as shown in Table 2.

As a practical example, Table 3 shows that in the U.S. in 1990, the 20 percent of households with the highest incomes actually received 47.2 percent of the total income of the country.

In general, if each household's income is growing at the same rate, then the level of inequality will stay constant. If the bottom quintile income grows faster than the average growth rate, income inequality will decrease because the poorest households will be catching up. If the bottom quintile grows more slowly than the average growth rate, however, income inequality will increase because the poorest households are not keeping up and are falling further behind. When income inequality remains constant, it means that household incomes are growing at the same rate for all groups. When income inequality increases, it roughly means that the richest and poorest households are growing further apart.

There are several different numerical measures of inequality, but each conceptually describes the area on the Lorenz curve graph between total equality and the actual income distribution. The more area between the two curves, the more inequality that exists. The most common of the measures include the Gini coefficient, Theil's Index of Inequality, and Atkinson's Measure of Inequality.

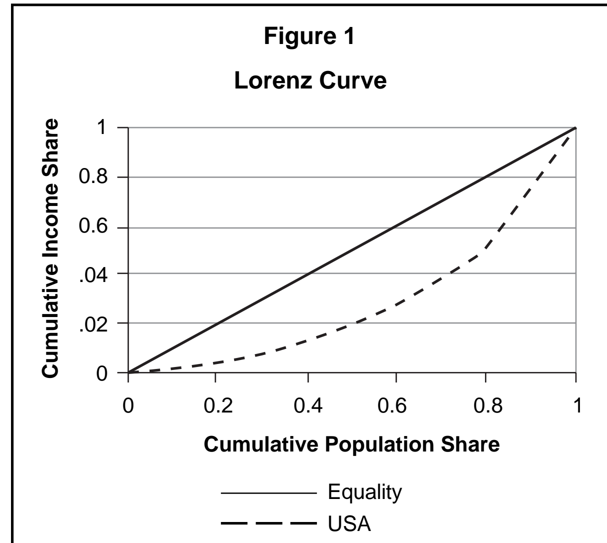


Table 1

Total Equality

Quintile	Percent of total income
1	20%
2	20%
3	20%
4	20%
5	20%

Table 2

Low Level of Inequality

Quintile	Percent of total income
1	16%
2	18%
3	20%
4	22%
5	24%

Table 3

Inequality in U.S.A. in 1990

Quintile	Percent of total income
1	3.8%
2	9.5%
3	15.7%
4	23.8%
5	47.2%

inverted U hypothesis. The factors identified frequently include city size; the population's average income level, educational attainment, industrial structure; and level of discrimination.[7]

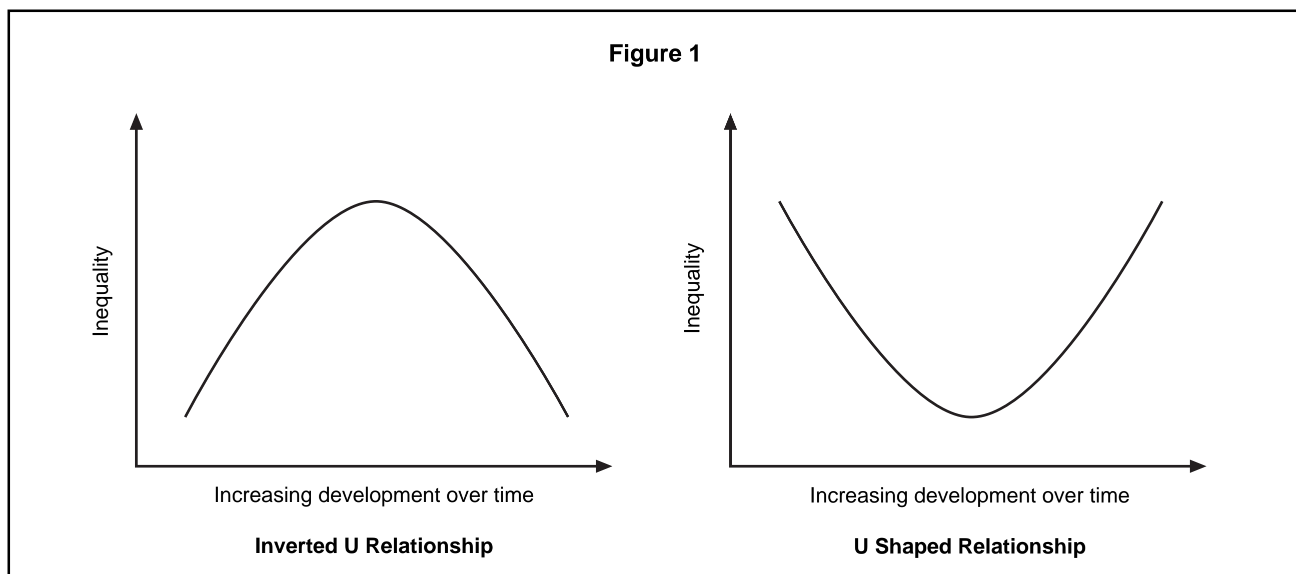
Researchers have frequently debated whether increasing city size leads to increasing income inequality. A number of reasons have been advanced to explain why a positive relationship should exist between these two factors. One reason is that monopolies will have greater rates of return in larger cities than in smaller cities. Examples of monopolies in this context are landlords, whose rent will increase with greater demand, and newspapers, which frequently have little direct competition.[8] Another reason is that the amenities structure will widen the skilled-unskilled wage differential as a city grows. Others have claimed that human capital markets function more smoothly as cities grow, leading to a reduced rate of return, and thus income inequality should decrease with increasing city size. That is, education and training programs increase the overall level of human capital in a city, thereby decreasing the benefits accrued to an additional worker. Long *et al.* found evidence that income inequality increases with city size in their study of 79 metropolitan areas.[9]

Complicating the city size-inequality matter is the issue of average, or mean, income. Both city size and inequality appear to be related to the average income within a city. Kuznets theorized that average income was negatively related to income inequality and several studies have supported this idea.[10] There is also evidence that average incomes are higher in larger cities.[11] If city size affected inequality only through average income, then city size would be negatively related to income inequality. Long's finding of a positive relationship between city size and inequality suggests that city size acts upon inequality in more ways than just through average income.

In addition, many researchers have investigated the link between education and inequality. One study, using data from the 1950 and 1960 Census of Population reports, concludes that educational attainment has a significant inverse correlation with inequality.[12] In other words, as the overall level of education increases, income inequality decreases. Average educational attainment leaves something to be desired as a measure, however. Educational inequality relates more easily to income inequality. Several studies of U.S. metropolitan areas and states have found that educational inequality is positively related to income inequality[13]. It seems straightforward that a high degree of educational inequality could lead to a high degree of income inequality (with more education leading to high incomes and less education translating into lower incomes). It is also easy to see how income inequality could lead back to educational inequality (stable, secure home lives and schools with resources are likely to provide one with a better education). Nevertheless, one must be careful when asserting that educational inequality *causes,* rather than is *related to,* income inequality.

Scholars have also frequently targeted the industrial and occupational structure of regions as a likely determinant of the level of inequality. One study finds that 30-55 percent of changes in wage inequality within U.S. states can be explained by a decline in durable manufacturing employment.[14] Another study finds that the relative number employed in manage-

Figure 1



Inverted U Relationship **U Shaped Relationship**

rial and professional occupations is positively related to inequality growth.[15] Durable manufacturing provides employment with relatively high incomes for workers without a college education. The possibility that former manufacturing workers have not been able to find new employment with equivalent pay would explain the link between a decline in manufacturing and an increase in inequality.

Additional factors that researchers have examined include discrimination and the level of state expenditures. A study of U.S. states finds that racial discrimination is the most important factor in determining the level of income inequality. This analysis measures the effects of racial discrimination by the percentage of non-white persons in the state population.[16] Another study finds that per capita educational expenditure is a robust predictor of inequality within a state.[17] Interestingly, the finding is that inequality increases as education expenditures rise.

Contemporary Picture

All of the studies cited above use relatively old data, from or before 1980. To obtain a more current picture of urban income inequality, the Gini coefficients presented in Table 1 were calculated using 1990 Census of Population data. In order to reach a more highly refined conclusion about the relationship between city size and inequality, as well to gain some insight into other factors that affect urban inequality, socioeconomic data on the thirty metropolitan areas were added to the Ginis. The additional data are similar to the kinds of variables that previous researchers have investigated, including education, industrial structure, racial discrimination, and state per capita expenditures, as well as city size and median income. The following variables were included in the model specifications:[18]

GINI = f (MEDINC, HH, EXPEND, DURMAN, PUBADM, TEACHRS, RACE, EDUHI, EDULOW)

Where,

GINI — Gini coefficient for household income distribution in the metropolitan area, the dependent variable in each model.

MEDINC — Median household income in the metropolitan area in thousands of dollars.

HH — Number of households in the metropolitan area, in tens of thousands (representing the size of the city).

EXPEND — Per capita state government expenditures in 1990, measured in U.S. dollars.

DURMAN — Percentage of total metropolitan area employment that is durable manufacturing employment.

PUBADM — Percentage of total metropolitan area employment that is public administration employment.

TEACHRS — Percentage of total metropolitan area employment that is elementary school, secondary school, and college employment.

RACE — Percentage of metropolitan area population that is non-white, including Hispanics.

EDUHI — Percentage of metropolitan area population, 25 years and older, with educational attainment above the bachelor's degree level (master's, professional, and doctoral degrees).

EDULOW — Percentage of metropolitan area population, 25 years and older, with an eighth grade or lower formal education.

A number of models with overlapping specifications were constructed and coefficients were estimated using the ordinary least squares (OLS) method of regression analysis. The Washington, D.C. metropolitan area was not included in the regressions due to the lack of comparable data for the EXPEND variable. The coefficients and their corresponding p-values are reported in Table 2.

As seen in Table 2, the HH variable is highly significant in every specification of the model. The positive relationship between city size and inequality remains significant even when the two largest cities, New York and Los Angeles, are removed from the dataset. This result shows that larger cities tend to have a higher level of income inequality, when all the other variables remain constant.

The median income is significantly negatively related to inequality in each specification. This strong finding means that holding all other factors constant, cities with higher median incomes tend to have a lower level of inequality. This result lends support to Kuznets' theory of a negative relationship between income and inequality.

Very low and very high levels of educational attainment both appear to be positively related to income inequality. This relationship makes sense, as extremes at either end of the education distribution would increase education inequality, and thus be associated with increased income inequality. The causality is not clear, however. Educational inequality may lead to income inequality at the same time that income inequality leads to unequal educational outcomes.

The industrial structure variables—DURMAN, PUBADM, and TEACHRS—were expected to be negatively related to inequality, as these industries tend to provide employment with near median level pay. It was thought that the greater the amount of middle class employment, the more equal the income distribution would be. None of the three industrial structure variables seem to have a strong relationship with the level of income inequality, however. The variables DURMAN and PUBADM were slightly more significant than the variable TEACHRS. It is possible that the numbers of government and durable manufacturing workers are correlated with the size of the city and/or the median income level, and thus the OLS method has difficulty isolating the effects of each of the three variables, a problem of multicollinearity.

The RACE variable was expected to be positively related to inequality because of the presence of racial discrimination, after controlling for the influence of other factors. Indeed, the RACE coefficient had the expected positive sign in each of the runs. It was significant only in model (3), however. These results provide some evidence, albeit weak, that racial discrimination is associated with higher levels of inequality.

The EXPEND variable was expected to have a negative relationship with inequality as increased state spending might lead to better conditions for those at the lower end of the income distribution. The data provided no proof that such a relationship exists, however, since the coefficient of this variable was not significant.

Table 2

OLS Regression Results
(29 Observations)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Intercept	0.467** (.000)	0.413** (.000)	0.444** (.000)	0.413** (.000)	0.444** (.000)	0.405** (.000)	0.456** (.000)
MEDINC	-0.000** (.001)	-0.000** (.000)	-0.000** (.000)	-0.000** (.000)	-0.000** (.001)		-0.000** (.000)
HH	+0.000** (.004)	+0.000** (.003)	+0.000** (.003)	+0.000** (.000)	+0.000** (.000)		+0.000** (.000)
EXPEND	+0.000 (.393)	+0.000 (.652)	-0.000 (.956)				
DURMAN	0.064 (.272)				0.041 (.574)	-0.154 (.055)	
PUBADM	-0.048 (.462)				-0.072 (.412)	-0.242* (.035)	
TEACHRS	-0.418 (.107)				0.201 (.229)	0.177 (.412)	
RACE	0.022 (.222)	0.017 (.381)	0.043* (.025)				
EDUHI	0.621* (.014)	0.231 (.069)	0.196 (.158)	0.257* (.035)			
EDULOW	0.207* (.024)	0.235* (.017)		0.267** (.001)			
Adj. R^2	0.755	0.711	0.639	0.725	0.541	0.125	0.530

P-values are in parentheses.
* significant at the p<.05 level
** significant at the p<.01 level

CALCULATING GINI COEFFICIENTS

The method used to calculate Gini coefficients for U.S. Metropolitan Areas could, in general, be applied to any income distribution. The Bureau of the Census reports U.S. Metropolitan Area income data as frequency counts in nine income classes:

1. less than $5,000
2. $5,000 to $9,999
3. $10,000 to $14,999
4. $15,000 to $24,999
5. $25,000 to $34,999
6. $35,000 to $49,999
7. $50,000 to $74,999
8. $75,000 to $99,999
9. $100,000 or more

The means of the income classes were assumed to be the average level of income within each income class, except for the “under $5,000” and the “$100,000 or more” classes. A mean income of $4,000 was assumed for the “under $5,000” class. The mean income of the open-ended “$100,000 or more” class was calculated by subtracting the amount of income in the other eight classes from the total income of all nine classes, and then dividing this difference by the number of households in the top income class. The total income of all nine classes was found by using the overall mean income figure included in the U.S. Census data.

Next, the total number of households was divided into quintiles, and linear interpolation was used to find the income levels that divided the quintiles. (Linear interpolation assumes that the households that fall within an income class are evenly spaced between the lower and upper bounds of the income class.) When the dividing income levels fell within an income class, the income class was split into smaller income classes. For example, if the dividing line between the second and third quintiles was $30,000, half the households in the $25,000 to $34,999 income class would form a new $25,000 to $29,999 income class and half would form a $30,000 to $34,999 class. The total income of each income class was found by multiplying the mean of that class by the number of households in the class. The total income of quintiles was found by summing the total incomes of the income classes within the quintile. These quintile incomes were converted into percentages of total overall income and used in the Gini coefficient formula adjusted from that found in Paul D. Allison’s “Measures of Inequality,” *American Sociological Review,* vol. 43 (December 1978), p. 867.

The Gini coefficient formula used by the author is the following:

$$\text{Gini} = (2/n)[q_1 + 2q_2 + 3q_3 + \ldots + iq_i] - [(n+1)/n],$$

where $q1<q2<q3$, q_i = the percent of the total income within the ith quintile, and n = the total number of quintiles.

The results presented in Table 2 generally confirm the work of previous researchers. The findings support the theory that city size is positively related to inequality, although *why* this is true remains somewhat of a mystery. Kuznets’ theory of an inverse relationship between income and inequality was supported by the 1990 data. Education inequality was positively associated with income inequality as other researchers have found. The evidence that racial discrimination influences inequality was weaker than what other researchers have found. Finally, industrial structure and state expenditures were not were powerful in explaining inequality. This finding is at odds with what some researchers have found.

CENTRAL CITY-NOT IN CENTRAL CITY COMPARISONS

In addition to allowing comparison between different cities, an inequality measure such as the Gini coefficient can be used to look at differing levels of inequality within a single metropolitan area. Specifically, the data allows one to calculate separate Gini coefficients for the central city and the “not in central city” parts of a metropolitan area. This type of internal comparison was performed for 14 cities using the 1990 Census data (see Table 3). In all 14 cases, the central city has both a *higher level of inequality* and a *lower median income* than the “not in central city” area or the metropolitan area as a whole. The intuitive explanation of this pattern is that the very rich and the very poor are the citizens of the central cities.

An examination of Central City-Suburban Comparisons in Table 3 leads to two important questions: Why do central cities have higher levels of inequality than surrounding suburban areas? What accounts for the variation seen in the central city-suburban Gini differences? Atlanta’s suburban area has a much lower Gini than its central city. San Antonio’s subur-

Table 3

Central City-Suburban Comparisons, 1989

City	Gini	Median income	Households
Atlanta MSA	0.385	$36,051	1,056,929
Atlanta MSA Central	0.495	$22,976	175,678
Atlanta MSA Not in central city	0.359	$38,359	881,251
Boston CMSA	0.389	$40,666	1,545,347
Boston CMSA Central	0.405	$31,389	516,126
Boston CMSA Not in central city	0.373	$45,621	1,029,221
Chicago CMSA	0.397	$35,918	2,903,236
Chicago CMSA Central	0.418	$26,921	1,293,667
Cleveland CMSA	0.396	$30,332	1,058,648
Cleveland CMSA Central	0.409	$20,231	357,441
Cleveland CMSA Not in central city	0.370	$35,761	701,207
Denver CMSA	0.380	$33,126	739,001
Denver CMSA Central	0.416	$26,103	265,430
Denver CMSA Not in central city	0.355	$37,161	473,571
Detroit CMSA	0.395	$34,729	1,724,767
Detroit CMSA Central	0.435	$21,202	489,054
Detroit CMSA Not in central city	0.367	$40,003	1,235,713
Houston CMSA	0.409	$31,488	1,333,707
Houston CMSA Central	0.437	$26,159	677,919
Houston CMSA Not in central city	0.373	$37,531	655,788
Los Angeles CMSA	0.407	$36,711	4,909,218
Los Angeles CMSA Central	0.431	$31,963	1,888,247
Los Angeles CMSA Not in central city	0.390	$39,972	3,020,971
Milwaukee PMSA	0.375	$32,316	538,179
Milwaukee PMSA Central	0.372	$24,626	262,150
Milwaukee PMSA Not in central city	0.348	$40,586	276,029
New York PMSA Central	0.453	$29,922	2,835,787
New York PMSA Not in central city	0.424	$50,228	413,018
Portland, OR CMSA	0.378	$31,071	576,083
Portland, OR CMSA Central	0.403	$25,192	207,397
Portland, OR CMSA Not in central city	0.358	$34,350	368,686
San Antonio MSA	0.403	$26,092	451,731
San Antonio MSA Central	0.404	$23,584	327,403
San Antonio MSA Not in central city	0.385	$33,172	124,328
Seattle CMSA	0.369	$35,047	1,003,337
Seattle CMSA Central	0.400	$28,373	348,634
Seattle CMSA Not in central city	0.348	$38,316	654,703
St. Louis MSA	0.386	$31,774	923,639
St. Louis MSA Central	0.405	$21,285	242,712
Washington, DC—DC only	0.449	$30,727	249,034
Washington, DC MSA	0.361	$46,884	460,785
Washington, DC MSA Central	0.427	$33,910	343,449

Source: U.S. Bureau of the Census, *Census of Population and Housing, 1990, Metropolitan Areas, Social and Economic Characteristics,* Table 37 (Washington, D.C., November 1992).

Note: Gini calculations by author.

ban area has a Gini relatively close to that of its central city. Why are these two cases different? Seattle and Milwaukee, which have low metropolitan Ginis, have low central city Ginis as well. On the other hand, Washington, D.C. has a low metropolitan Gini but a very high central city Gini, suggesting a greater disparity between city and suburbs. New York, Los Angeles, and Houston have both high metropolitan Ginis and high central city Ginis.

Paul Jargowsky has found that low-income whites tend to be spatially dispersed within a metropolitan area whereas low-income minorities tend to be spatially concentrated in central cities. Documented patterns of racial discrimination in housing clearly play a large role in the concentration of low-income racial minorities.[19] A large number of residents on the low extreme of the income distribution will increase overall inequality.

The variation in the difference between central city and suburban Ginis is not easily accounted for with a pool of only 15 comparisons. More observations are needed to shed light on this question. Possible explanations could have to do with the size of the central city relative to the suburban area, the "age" (in terms of recent economic growth) of the city and its suburbs, regional location within the United States, and historic levels of racial discrimination.

Outlook

Recent trends in America's cities include the implementation of New Urbanist ideas and the use of annexation by city governments. New Urbanism refers to a movement by planners to remake city centers into mixed-use districts containing both commercial activity and residential units, in an effort to bring people back to downtowns. How will this affect inequality? To the extent that middle income people are drawn back into the city from the suburbs, inequality within central cities could be lessened. Overall metropolitan inequality will remain unchanged except for any benefits that increased local economic activity brings to low income people already living in the central cities.

Cities annex surrounding areas to increase their tax base. City governments are typically afraid that without annexation, higher income people will choose to live outside city limits where taxes and social service expenditures are lower. By annexing suburban areas, cities can increase their tax base and are better able to provide the social services needed by their residents. Annexation likely reduces the level of income inequality within city limits by increasing the number of middle income city residents. It may also reduce inequality to the extent that the increased tax base positively affects the well-being of low-income residents through increased expenditures.

Conclusion

The *Austin American-Statesman* writes "The three Es of healthy community are the economy, the environment and social equity, according to urban planners."[20] In good economic times such as the late 1990s, an inequality measure such as a Gini coefficient can help policy makers get a sense of whether all income groups are benefiting or whether increased stratification is taking place. Inequality measures speak to the overall strength of the community and that elusive metric, "quality of life."

Several theories have attempted to explain the relationship between economic growth and income inequality. A number of studies, including this one, provide evidence that larger cities are more likely to have higher levels of inequality. Census data from 1990 also showed a negative relationship between median income and inequality, which is in line with Kuznets' hypothesis of an inverse relationship between income and inequality.

Education clearly is related to inequality. This and several other studies show that inequality in educational attainment is positively associated with income inequality. Causality is unclear in this relationship, however. Strong cases can be made for each direction of causality and it seems likely that a cycle of causality exists.

The level of inequality within metropolitan areas has received only limited research attention. The data exist to facilitate a deeper look into the factors that influence income distributions within urban areas. Simply having a measure of inequality to benchmark can be a useful tool for city governments in evaluating the success of large-scale development projects and their effect on citizens. The data also exist to examine differing levels of inequality within a metropolitan area. Regional councils of governments would be appropriate bodies to analyze how inequality differs within a wider area. A great disparity between inequality levels of the central city and the suburbs, such as the one that exists in Atlanta, is dramatic evidence that a single metropolitan area is actually composed of two very different areas. This kind of disparity can lead to the kind of psychological distance that allows social and political fracturing to occur.

If income inequality is a troubling trend in American cities, then what can local governments and communities do to reverse the trend? This question is a most difficult one for three reasons. First, the causes

of inequality are still very much up for debate. Secondly, if the specific causes of growing inequality could be determined, it would still be hard to come up with appropriate policies. If the decline of manufacturing is responsible for some inequality growth, no simple remedy exists. Likewise, if larger cities mean higher inequality, a metropolitan area can not reverse growth and shrink itself. A factor like educational inequality is already very much a public concern and the subject of fierce debate. Once again, no simple policy solution reveals itself. Finally, if causes of inequality were plainly known, and remedies relatively straightforward, only the political will to act would be necessary. Income inequality is a distributional issue, and in order for one group to gain a greater share of total income, another has give up some share. It is not as stark as taking away a dollar from one household to give to another household, fortunately. Every household's incomes can rise. If income inequality is to decrease, though, lower incomes would have to rise more swiftly than higher ones. Policies with explicit re-distributional goals will likely remain a hard sell given the current political climate.

LBJ

NOTES

1. U.S. Census Bureau, *Share of Aggregate Income Received by Each Fifth and Top 5 Percent of Households, 1967 to 1994*, http://www.census.gov/hhes/income/incineq/p60tb2.html. Accessed: March 8, 1999 (government information Web site).
2. James K. Galbraith, *Created Unequal: The Crisis in American Pay* (New York: The Free Press, 1998), p. 4.
3. Denny Braun, "Multiple Measures of U.S. Income Inequality," *Review of Economics and Statistics*, vol. 70 (August 1988), p. 398.
4. Norman Cloutier, "Metropolitan Income Inequality during the 1980s: The Impact of Urban Development, Industrial Mix, and Family Structure," *Journal of Regional Science*, vol. 37, no. 3 (August 1997), pp. 462-463.
5. Ibid., pp. 462-463.
6. Folke Dovring, *Inequality: The Political Economy of Income Distribution* (New York: Praeger, 1991), p. 100.
7. Folke Dovring, *Inequality: The Political Economy of Income Distribution* (New York: Praeger, 1991).
8. Cloutier, "Metropolitan Income Inequality," pp. 462-463.
9. James E. Long, David W. Rasmussen, and Charles T. Haworth, "Income Inequality and City Size," *Review of Economics and Statistics*, vol. 59 (May 1977), p. 246.
10. Ahmad Al-Samarrie and Herman P. Miller, "State Differentials in Income Concentration," *American Economic Review*, vol. 57 (March 1967), pp. 60-72; John A. Bishop, John P. Formby, and Paul D. Thistle, "Explaining Interstate Variation in Income Inequality," *Review of Economics and Statistics*, vol. 74 (August 1992), pp. 553-557; Long et al., "Income Inequality and City Size"; and Braun, "Multiple Measures."
11. Long et al., "Income Inequality and City Size," p. 244.
12. Al Samarrie and Miller, "State Differentials."
13. Bishop et al., "Explaining Interstate Variation"; Braun, "Multiple Measures"; and Cloutier, "Metropolitan Income Inequality." Braun and Bishop et al. use the standard deviation of years of school completed as a measure of educational inequality. Cloutier adds the percentage of people with less than a ninth grade education to the percentage of people with graduate degrees to create a measure of educational inequality.
14. Andrew B. Bernard and J. Bradford Jensen, "Understanding Increasing and Decreasing Wage Inequality," NBER Working Paper No. 6571 (1998).
15. Cloutier, "Metropolitan Income Inequality," p. 476.
16. Al Samarrie and Miller, "State Differentials."
17. Bishop et al., "Explaining Interstate Variation," pp. 553-557.
18. GINI is calculated by the author using 1989 household income data from the 1990 U.S. Census. The variables MEDINC, HH, DURMAN, PUBADM, TEACHRS, RACE, EDUHI, and EDULOW are all calculated from 1990 U.S. Census. EXPEND is per capita state expenditures for fiscal year ending in 1990 as reported in the *Statistical Abstract of the United States*, 1992, Table 460.
19. Paul Jargowsky, *Poverty and Place: Ghettos, Barrios, and the American City* (New York: Russell Sage Foundation, 1997), pp. 61-68.
20. Editorial, *Austin American-Statesman* (March 4, 1999), sec. A, p. 14.

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ELECTRONIC COMMERCE IN THE PUBLIC SECTOR:

POLICY CHALLENGES IN SECURING ELECTRONIC COMMERCE WITH A PUBLIC KEY INFRASTRUCTURE

BY BRANDON ATKINSON

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ELECTRONIC COMMERCE (EC), THE BUYING AND selling of goods over the Internet, is reshaping the business world. Dell Computer increased its daily online sales of personal computers from $1 million to $5 million per day from 1997 to 1998.[1] Amazon.com increased sales from less than $16 million during 1996 to over $148 million during 1997.[2] Many other retail or office-based businesses, such as Macy's, Cisco Systems, and Saturn Corporation, have created Internet "store fronts" to complement their traditional sales base. Accounting and consulting firm Ernst & Young surveyed 125 traditional retailers in December 1998 and found that 76 percent were, or soon would be, selling their goods online. In 1997, the same figure was only 36 percent.[3] A significant factor in the rush to use the Internet to conduct business is the tremendous growth rate in the number of U.S. citizens online. By the end of 1997, there were 100 million people online, whereas

experts project that there will be more than one billion by 2005. Indeed, Internet traffic is growing at the astounding rate of 100 percent every 100 days.[4]

Having seen the potential of EC in the private sector, government officials are developing EC initiatives of their own. Many analysts predict that EC will change the way the public sector works. State governments want to be ready for the change; Jon Fullinwider, Los Angles County Chief Information Officer, illustrated the need for governments to adapt when he said, "Why does business always have to step out four or five steps before government does? If we don't make the necessary changes it's going to cost us far more. . . . We don't want business to leave California."[5] Governments are catching up with the private sector in using EC, and in some instances, governments are pushing the private sector to catch up with them.

The success of EC in the public sector largely depends on government officials overcoming a handful of challenges. Many important EC applications require agencies to quickly and inexpensively authenticate the sender of an electronic document, verify the integrity of the information transmitted, and ensure the confidentiality of private information. A public key infrastructure (PKI) provides government agencies with the ability to meet those needs. The development of a PKI, however, requires that legislators address several important policy questions and enact supportive legislation.

PUBLIC KEY INFRASTRUCTURE: WHAT IS IT AND WHY IS IT IMPORTANT?

In simple terms, a PKI is a set of laws, policies, and technological tools that allow people to make secure and legally recognized transactions over the Internet, such as signing a contract. The lynchpin to the success of many EC projects is the development of a PKI. There are five essential components: 1) a public key, 2) a private key, 3) a certificate, 4) a repository, and 5) a set of supporting laws and regulations. There are different ways of using a PKI, which have varying degrees of security.

An example demonstrates how a PKI would work in a transaction that requires a high level of security. Consider an example involving a state government agency, a construction company, and a trusted third party called a Certificate Authority (CA). All participants have a public key, which each party has access to, and a private key, to which only the owner has access. The keys perform inverse functions; the public key decrypts an electronic document that was encrypted by the corresponding private key. The CA issues the public and private keys, provides a secure repository that holds a directory of public keys, and verifies the identity of the public key holders.

In the example, a state transportation agency has posted online a request for proposals to build a major highway. John's Construction Company downloads the bid package and fills it out electronically. The company then locks the electronic document with its private key and the state's public key. A digital signature (a long string of numbers) is created when the company locks the document with its private key. The state agency electronically receives the bid and uses its private key to decrypt the document's message. Then, the agency reviews the certificate that is attached to the document, and is automatically connected to the CA's online repository, which verifies both that the owner of that digital signature is John's Construction Company and that the document was not altered *en route*.

A PKI has many qualities that add the necessary security and certainty to Internet transactions. The sender's digital signature allows the recipient to authenticate the document almost immediately. The sender and recipient are guaranteed that the document's message was not intercepted and read (or altered), because only the recipient's private key can decrypt the document. It is important, from the recipient's perspective, that this system also prevents a sender from denying the integrity or authenticity of the information sent. Without such certainty, EC becomes problematic. For example, if John's Construction Company lost the bid to another company, John's Construction Company could respond that the state did not receive the correct bid from the company, which would have been much lower than the lowest bid received by the state agency.

APPLICATIONS FOR EC AND DIGITAL SIGNATURES IN THE PUBLIC SECTOR

Surveying the many forms of electronic commerce in the public sector illustrates the important role a PKI could play in supporting these initiatives. Transactions can take place between state agencies or departments, between government and taxpayers, between government and the private sector, or between state governments, for example. So far, the most significant EC initiatives have involved procurement systems. Other services have included selling local souvenirs, registering motor vehicles, applying for permits, submitting college applications, issuing car titles, and filing taxes. Examples of federal, state, and local EC initiatives illustrate the wide applicability of EC and digital signatures in the public sector.

The Texas legislature enacted several EC-related laws in 1997, and, within six months, the Department of Information Resources adopted regulations for the use of digital signatures. The state's vision was to tap into the potential for EC to cut costs, improve government service delivery, and increase efficiency. The legislation promoted the use of EC technologies to improve procurement processes. Among other requirements, it required the Department of Economic Development to establish an Electronic State Business Daily and it required the General Services Commission to determine the feasibility of an Electronic Commerce Network.

The Electronic State Business Daily is an information clearinghouse for the public and vendors about state business activity. The database includes all state purchases or contracts over $25,000 and other state business deemed to be of public interest by the Texas Department of Economic Development. Agencies must make their entire bid package or request for proposals available on the Electronic State Business Daily or at least provide the information a vendor would need to compete for the contract. The vendor can search the database by state agency or bid type.[6]

A related project, the Texas Marketplace, also uses the Internet to support the State's procurement activities <see: http://www.texas-one.org>. It provides businesses with information on state procurement practices and opportunities; provides state agencies with information on state-approved vendors, including reports on past performance and product information; and provides general information on the state's purchasing history. It also provides access to a database of historically underused businesses.

The requirement to assess the feasibility of establishing an Electronic Commerce Network resulted in Texas' participation in the EMall, an online multi-state procurement project <see: http://www.emall.isa.us>. The other participants in this pilot project, which began in October 1998, are Massachusetts, Idaho, New York, South Dakota, Utah, and Washington. The project allows authorized representatives from participating states to visit a Web site, identify needed products, compare prices among vendors, and purchase the products they need. Each state had to recruit at least one qualifying vendor to participate in the project. The EMall concept is new and untested, but officials see many potential benefits, such as rapid price comparisons, fewer data input errors, no paperwork, reduced transaction cost, and a simple, single "electronic store front." In addition, states expect that vendors will reduce their prices because of the large quantity of orders. Many states are using this project as their first step in developing their capacity for electronic procurement. As David Moon, Utah's chief information officer, said:

> "Our reason for participating in the project is not to get volume purchasing. If that comes about, it's gravy. But if we can put structures from the electronic mall pilot into place with vendors on the Web, then we're that much further in moving our transactions online and being able to conduct them more efficiently with the suppliers."[7]

The legislation passed by the Texas legislature in 1997 also created EC pilot projects at the agency level. One bill charged the Health and Human Services Commission with coordinating the procurement processes of all health and human service agencies to ensure they are using the newest practices and EC technologies. This will allow the agencies to participate in group-purchasing agreements and negotiate prompt payment discounts.[8]

A final bill focused on the Texas Department of Transportation (TxDOT). This bill permitted TxDOT to accept driver's license applications online and issue the licenses online. In addition, the bill authorizes TxDOT to develop standards for accepting electronic fund transfers and credit cards as valid forms of payment. Another section in this bill allows TxDOT to establish an electronic bidding process for highway construction and maintenance contracts. The system must allow vendors to submit their bids over the Internet without sending an additional hardcopy through the postal service.[9]

The contractual agreements made in such electronic bidding systems require an authenticating signature—an ideal application for digital signatures. Given that states are increasingly turning to online bidding systems, it is important to understand the vital role digital signatures can play in such systems. When using digital signatures, an authentic record is established of who made a purchase and when, thereby providing fiscal accountability. Vendors can furnish agencies with receipts for services provided or products sold that the agency can use as a proof of purchase. Agencies and vendors are legally responsible for the product orders or service agreements because the security of digital signatures creates a legal presumption that the certificate correctly identifies who the sender is.

The U.S. Internal Revenue Service (IRS) is testing the feasibility of a national Internet tax filing system. In August 1998, it contracted with VeriSign Inc. to develop a PKI so that tax filers could use digital signatures to file their taxes and send other official documents through the Internet. Selected IRS employees will test the system.

Many governments have developed EC applications to improve service delivery. Pennsylvania's official World Wide Web site allows taxpayers to download forms for their income, property, and corporate taxes <see: http://www.state.pa.us>. Application forms are available for auto licensing, titling, or registration, as well as for fishing licenses or voter registration. In Indiana, the Indianapolis site allows city and county residents to pay for parking tickets, to access court records, to apply for permits, and to request the repair of potholes <see: http://www.indygov.org>. The Seattle, Washington site, known as the Public Access Network, offers access to its vast database system that contains more than 10,000 documents <see: http://www.cu.seattle.wa.us>. Citizens can also track building permit applications, make service requests for streetlight or pothole repairs, pay parking tickets, or search for animals available for adoption. In Illinois, Chicago has a site that sells city souvenirs <see: http://www.ci.chi.il.us>.[10]

In short, many federal and state officials realize the tremendous potential of EC technologies and applications to revolutionize the way governments do business. They are taking steps to understand better what services and procurement practices they can and should reengineer into a digital format. They are participating in and shaping what many public officials believe is an EC revolution. Furthermore, digital signature technology promises to be an important part of many of these initiatives.

CHALLENGES TO THE GROWTH OF EC IN THE PUBLIC SECTOR

To maximize the potential electronic commerce in the public sector, there are several challenges that government officials should address. It is critical that citizens have access to and confidence in the Internet. Governments need to recruit and retain information technology (IT) specialists who can develop EC applications. In many cases, states need to pass laws that authorize certain standards for electronic payment for government services. When governments provide online data sets or other valuable information, officials need to decide when they should charge a user fee and when access should be free. For procurement-enhancing EC projects, government business partners must also have online access. Implementing many forms of EC requires the development of a PKI, which includes new laws that recognize digital signatures as the legal equivalent of manual signatures. Compounding the difficulty of these issues, government officials need to address the problems without diverting attention from the year 2000 computer problem.

A fundamental challenge many EC initiatives face is the belief among many users that the Internet is not a safe way of conducting business. Many public officials and analysts recognize that the lack of public trust in the Internet is one of the most significant barriers to EC. The unmonitored, open, and "no-holds-barred" nature of the Internet make many users believe it is dangerous to send their credit card numbers or personal information over the Internet. In some instances, this fear is valid. For example, hackers hijacked the L.L. Bean Web site in 1998, put up a look-alike storefront, and collected credit card numbers from unknowing consumers.[11] Also, a computer savvy thief can intercept and read a consumer's credit card number if precautions are not taken. Although transactions over the Internet are generally safe and security breaches are rare, using digital signatures would further mitigate any risk.

As EC has facilitated the rapid exchange of personal and financial information, it has also increased the risk of privacy intrusions. Consumers may not be aware of how their information is used after they make an online purchase. For example, a Web site owner could maintain a record of an individual's online purchases and sell the information to an advertising agency without that consumer's knowledge. Furthermore, they could link their database with the databases of other Web sites to develop a more comprehensive profile of the individual consumer. The ease with which marketing agencies can electronically collect and distribute personal information makes the privacy risks particularly strong.

One of the more basic but serious challenges for many governments is recruiting and retaining IT staff. The Texas Department of Information Resources (DIR), in its *Biennial Report on Information Resources Management,* listed recruiting and retaining its IT personnel as one of its most pressing problems. The turnover rate has increased over the past five years, causing them to train non-IT staff to fill the void. Such training, however, has not addressed the problem sufficiently, because many of the newly trained staff leave for higher paying jobs in the private sector. David Debo, a systems analyst at TxDOT who is responsible for implementing the agency's electronic bidding system, said it is difficult to find IT personnel who will work for what the government is willing to pay. One coworker tripled his salary after leaving for a similar job in the private sector.[12] To address the turnover, DIR has recommended to the legislature a bill that would require trained staff to maintain employment with the state for at least five years after training or pay back the training costs.[13]

Government EC projects that provide access to vari-

ous forms of data need to consider whether to assess fees for such access or not. Most states are working to make their data collections available online, including information on state demographics, economic trends, and various reports. These efforts are often very expensive. The question arises, when governments provide such value-added services, should they recoup the cost of collecting and formatting the data? Is charging for this information inappropriate, when citizens have already paid for government services with their tax dollars? What if a citizen cannot afford to pay for the service? What if businesses compile this easily accessible information, format it in ways that have market value and sell it? For many governments, these issues remain unresolved. As the amount of data governments provide and the number of Internet users online increases in the coming years, this issue will gain in importance.

For services that do include a charge, many governments must develop standards and laws to authorize forms of electronic payment over the Internet. Before the Internet, users conducted most purchases requiring an electronic funds transfer over a closed network with high security. Because the Internet is open and information can be more easily intercepted, it is a less safe medium. Policy makers must decide how they will balance security concerns with the practical matter of needing to permit electronic fund transfers or credit card purchases online. Advancements in encryption technology, such as digital signatures, are providing some answers and security, but many states must still develop laws authorizing political sub-divisions to use such EC technology.[14]

The next challenge facing public officials is increasing public access to the Internet. Many of those who use government services, such as lower income households, do not have access to the Internet and cannot take advantage of online services. In response to this problem, some governments have sponsored community computer centers or installed kiosks in public areas. Similarly, many small businesses are not online. Texas policy makers recognized that all vendors the state does business with must have Internet access to use the state's Electronic State Business Daily. Therefore, legislation was enacted that instructed government agencies to provide vendors with availability to the Internet in government offices. The agencies were authorized to charge a fee for downloading information on these computers.[15]

When using EC technologies for procurement, government officials often depend on vendors having a Web site to support the transactions. Governments must develop incentives or requirements for vendors' Web pages to provide updated information, prices, and availability of products and services. Texas policy makers have taken a piecemeal approach to addressing this problem by focusing on IT vendors only. In 1997, legislation created a special status that IT vendors must apply for called Qualified Information Systems Vendor (QISV). The legislation authorizes the General Services Commission (GSC) to accept applications for QISV status over the Internet. To qualify, vendors must have Web pages with up-to-date catalogues of product and service information, including prices and availability. The GSC is required to maintain an indexed database of the information provided by the QISV's for use by state agencies and the public.[16]

"Implementing many forms of EC requires the development of a PKI, which includes new laws that recognize digital signatures as the legal equivalent of manual signatures. Compounding the difficulty of these issues, government officials need to address the problems without diverting attention from the year 2000 computer problem."

Compounding the difficulty of these challenges, the focus of both government funds and staff time has been on solving the year 2000 computer problem. For example, Texas passed legislation in 1997 allowing public agencies to adopt policies to use digital signatures. As of February 1999, none had adopted the policies. Jerry Johnson, Senior Policy Analyst for the Texas Department of Information Resources, said that, "there has been a lot of interest in digital signatures, but Y2K is in the way. After the Y2K issue, there will be an explosion in use."[17]

The most pressing issue state governments are facing is recognizing a signature in electronic form as a legal substitute for a manual signature. Nationally, this is the most legislated issue related to EC. As of February 1999, all but eight states have enacted related legislation. Two of the eight have passed legislation to form a task force to study electronic signatures, one has a bill waiting for the Governor's signature, and the other five have bills pending a floor vote. At least one state has enacted legislation or approved regulations about electronic authentication every month since

December 1997.[18] Just since September of 1998, Pennsylvania, Minnesota, California and North Carolina have passed legislation concerning electronic signatures. In the first month of 1999 alone, legislators in eleven states introduced bills. In short, public officials are working vigorously to update laws that are losing relevancy in an economy increasingly affected by electronic commerce and information technology.

Policy Issues to be Considered for Electronic Signature Legislation

When states develop electronic signature legislation, policy makers should consider several important policy questions. The question is not as simple as whether or not a state should recognize digital signatures as having the same force and effect as manual signatures. The U.S. Congress will likely address that issue in the 106th Session. Congressman Bliley, the Chairman of the House Commerce Committee, listed electronic authentication as a top priority issue for the coming session.[19] Senator Conrad Burns, the Chairman of the Senate Commerce Telecommunication Subcommittee, listed promoting the use of digital signatures as part of his "digital dozen"—a legislative package to protect consumer privacy.[20] State officials should consider the following seven questions when developing legislation:

1. Will the legislation be comprehensive or limited to basic principles?
2. To whom will it be applicable?
3. Will it be technology-neutral or -specific?
4. Will Certificate Authorities be public or private entities?
5. Will it include provisions for the liability of the Certificate Authority?
6. Will it include provisions for the liability of the digital signature subscriber?
7. Will it include provisions for the liability of an unauthorized signer of an electronic signature?

State lawmakers and their EC projects will benefit from exploring the answers to each of these questions.

EC will develop more rapidly under a clear and supportive legal structure. Without such a structure, legal uncertainties can undermine EC initiatives. If legislators do not address these questions, the judicial system, by default, might create policies. Do elected officials want to give up that authority? It may not be necessary for state lawmakers to address each question through legislation. Rather, states should consider how these policy issues affect and are affected by existing legal precedent and business environments. To flesh out the issues that all states should consider, the legislative and regulatory models of Utah and California prove useful, because (1) these states have served as models for legislation by other states, and (2) each state takes a comparatively different approach to establishing a legal foundation for the use of electronic signatures.

A Comprehensive or Limited Approach?

First, states should consider whether their legislation should be comprehensive or limited to basic principles. The 1995 Utah Digital Signature Act and the 1995 California Online Disclosure Act illustrate the two different models. In Utah, policy makers enacted comprehensive legislation that addressed all seven of the policy questions, whereas in California, statutory language included only basic principles, and the Secretary of State wrote basic and limited regulations.

California's electronic authentication bill enacted in October 1995 (Assembly Bill 1577), only 309 words in length, defines a digital signature, recognizes a digital signature as having the same force and effect as a manual signature, parties to whom the bill is applicable, and assigns the Secretary of State with the responsibility of establishing implementation regulations. The resulting California Code, adopted in 1998, was also limited in scope and detail. The code lists the attributes an acceptable electronic authentication technology must have, the current technologies acceptable to the state, and the issues public entities must address when using electronic signatures. Several states have emulated this model, including New Mexico, Texas and Nevada.[21]

The Utah Act is actually comprehensive, despite Utah policy makers calling it a "minimalist approach," because it has few mandates. The Utah digital signature act was the first ever passed in the United States. Policy makers wanted to enact such a law to facilitate the growth of EC and the use of digital signatures, while not over-regulating an emerging market. This statute includes twenty-seven sections, and covers issues such as licensure and qualifications of a certificate authority, suspension, revocation, and expiration of certificates, liabilities of repositories, and definitions of reliable and unreliable digital signatures. While several states have adopted Utah's com-

prehensive approach, including Illinois, Washington, Florida, and Georgia, their efforts are less detailed than those of Utah.[22]

TECHNOLOGY-NEUTRAL OR TECHNOLOGY-SPECIFIC?

With EC becoming an economic force, it is problematic that state laws and general convention require a handwritten signature to authenticate a document. States have begun addressing this problem, but the legal definition of a digital signature varies greatly, with some states not defining it at all and others misusing the term. The author of this paper has used the definition articulated by the law firm McBride, Baker & Coles (MBC), because the firm is nationally renowned for its work on digital signatures. MBC delineates two terms that states have used to legalize signatures in electronic form—digital signatures and electronic signatures. A digital signature is tied specifically to public key infrastructure technology. Legislation that recognizes only digital signatures is technology-specific. An electronic signature is a broader term that could refer to a variety of technologies, such as digital signatures, PIN numbers, digitally scanned manual signatures, dynamic signature technology, or something as simple as one's typed name. Most legislation using the broader term requires that the electronic signature be (1) unique to the person using it, (2) capable of verification, (3) under the sole control of the person using it, and (4) linked to the data in such a manner that if the record is changed, the signature is invalidated.[23] This type of law is technology-neutral.

The California statute is technology-neutral, and the Secretary of State developed codes that require electronic signatures to have specific authentication attributes. The law defines an electronic signature as "an electronic identifier, created by computer, intended by the party using it to have the same force and effect as the use of a manual signature."[24] The adopted code does provide a specific list of attributes an electronic signature must poses to have the same force and effect as a manual signature. The electronic signature must be: unique to and under the sole control of the person using it, capable of verification, and linked to the data such that if the data were changed, the digital signature becomes invalidated. Any technology can qualify if it creates a signature that has those attributes, but the Secretary of State must approve it. Presently, digital signatures and dynamic signature technology are the only qualified technologies. In basic terms, the latter is a system where one signs his name on a pad that digitizes the signature and inserts it into a document. Kansas, Iowa, Texas and Kentucky have followed the California technology-neutral model.[25]

As noted by the American Bar Association, there are several policy advantages to a technology-neutral approach. Given the rapid changes in information technology, a neutral approach prevents laws from becoming quickly antiquated. There is also the benefit of not creating market distortions by legislatively promoting a given technology. Technology-specific laws may have unintended consequences. They may stunt the growth of newer and better signature technologies. The risk is especially great considering that the market has not yet matured.[26]

The Utah Act is technology-specific. The law does not recognize electronic signatures other than digital signatures. It defines a digital signature as:

> a transformation of a message using an asymmetric cryptosystem such that a person having the initial message and the signer's public key can accurately determine whether: (a) the transformation was created using the private key that corresponds to the signer's public key; and (b) the message has been altered since the transformation was made.[27]

The technology-specific model allows Utah policy makers to create a statutory category for digital signatures different from that of manual signatures. The certainty provided by digital signatures prompted legislators to establish the legal presumption that the individual named on the digital certificate as the sender is the same person who sent the electronic document. Such a presumption is critical for courts to uphold the validity of electronic contractual agreements. Washington and Minnesota modeled their laws after Utah's by enacting technology-specific laws that treat digital signatures as a special statutory category.[28]

APPLICABILITY OF LEGISLATION

The applicability or scope of electronic signature legislation is another important policy issue that states should consider. Many states enacted limited legislation that is applicable to transactions only between public sector agencies. Another group of states formed a more expansive scope affecting all public and private sector communication. Some of these states originally had limited legislation and then expanded it as more applications developed.

The applicability of electronic signature legislation in California is limited. The state enacted a series of laws limited to a specific group or transaction. The laws apply only to communication with public entities, admission applications and residency determination forms for state community colleges, electronically filed securities exchange documents, reports and statements required under the Political Reform Act of 1974, and electronically filed certificates of death. One underlying assumption in limiting the applicability of digital signature legislation was that the private market would and should take care of private transactions. Policy makers also assumed that the judicial system was well equipped to address the issues that the codes and legislation did not. Texas, Arizona and Alabama also use this model of limited applicability.[29]

Utah developed a more expansive scope for its legislation. Although one digital signature law is limited to Notary Public acknowledgements, the other statutes are applicable to all public and private communications. One advantage of this approach is that legislators do not have to pass new laws or regulations every time they identify a new application for electronic signatures. This contrasts with California, where if an agency finds a new use for digital signatures it must seek legislative approval to implement it. States such as Florida, Georgia and Washington included Utah's broad language in their bills.[30]

PUBLIC OR PRIVATE CERTIFICATE AUTHORITIES?

States must consider whether they will authorize a public agency to act as a CA or leave it to the private sector. This decision is sometimes based on whether or not there are any private CAs operating in the state. If there were none, some states assigned an agency or department to act as a CA. Sometimes, this assignment is meant to be a temporary measure until the market matures, the demand for digital signatures increases, and private firms enter the market.

California law does not authorize a public agency to act as a CA, but does provide for regulation of private CAs. CAs must meet California's requirements or show proof of accreditation by a national or international accreditation body acceptable to the state. Nevada, Texas and New Hampshire have adopted California's market-reliant approach.[31]

Utah's legislation authorized the state Department of Commerce to act as a CA and to nurture the growth of private industry CAs. The department outsourced its CA responsibilities to a consortium of companies that it will regulate. Essentially, the state is trying to develop a market where no market existed. Washington, Florida, Maryland and Georgia also authorized state agencies to act as CAs.[32]

Assisting the states in their efforts, the federal government is developing national Certificate Authority. The U.S. General Services Agency (GSA) is spearheading the Access Certificates for Electronic Services (ACES) program. The goal "is to provide an expandable foundation to stimulate the widespread issuance of public key certificates and support the use of digital signatures as an authentication and document integrity technology."[33] The GSA will contract with a private certificate authority to distribute keys, maintain the key directory, and perform other necessary functions for all agencies using digital signatures. In the short term, ACES will provide a uniform PKI to agencies and the public for particular applications in the federal government. In the long term, GSA hopes that ACES will encourage the development of an interoperable national, if not global, PKI.[34]

LIABILITY ISSUES

States should consider what, if any, liabilities CAs, subscribers, and unauthorized digital signature signers face for misuse, abuse or neglect. With the exception of the states with the most comprehensive digital signature laws, states have not enacted legislation concerning liability. Some states, like California, have not yet legally defined the liability of CAs and digital signature subscribers, but plan to. Some states believe that the courts will have to decide on these issues regardless of what legislators do. Johnson, the Senior Policy Analyst from Texas, believes that "the laws won't mean much until they are tested in court."[35] A final group of states, like Utah, clarified the liability of CAs and subscribers in legislation.[36]

Utah enacted legislation addressing the liability of CAs, subscribers, and unauthorized signers of digital and electronic signatures. The Utah Act has language protecting consumer rights and penalizing CAs for abuse or neglect. Utah adopted a negligence standard, making it the subscriber's burden to prevent unauthorized use of his/her private key. If unauthorized persons acquire and use a subscriber's private key, he/she can be punished as if the private key were physical private property. In addition, legislators introduced a new bill on identification number fraud in January 1999, which would make it a crime when "a person, with intent to defraud or deceive, possesses, acquires, uses, or divulges the identification number of another." This bill explicitly states that a digital signature is an identification number. Florida, Illinois, Washington, and Minnesota modeled their liability language after the Utah Act.[37]

CONCLUSION AND RECOMMENDATIONS

Federal, state, and local governments are using EC and digital signatures to reshape the way they do business. As the increasing number of new electronic signature statutes illustrates, the first important step toward facilitating EC is developing the legal infrastructure that supports electronic signatures. The case studies of California and Utah provide a basis for analyzing the existing inconsistent patchwork of legislation. Business leaders and other national organizations have expressed concern that the variations in legislation inhibit the use of electronic signatures and EC in general. A report by information technology consultants GartnerGroup found that, "If anything, online contracting is a model of inconsistency, with wildly different laws on a state-by-state basis. This has important ramifications for enterprises planning to adopt electronic commerce initiatives . . . and limits the use of electronic authentication."[38] As the GartnerGroup report recognizes, since the market is immature and evolving, the lack of established standards is to be expected and healthy, because it is the result of experimentation.[39] This a classic public policy challenge: balancing state autonomy and creativity with interstate compatibility. The task now is to begin identifying best practices that states and the federal government should implement to increase certainty and consistency, while facilitating the expansion of EC without over-regulating the electronic signature market.

"As noted by the American Bar Association, there are several policy advantages to a technology-neutral approach. Given the rapid changes in information technology, a neutral approach prevents laws from becoming quickly antiquated."

A limited approach to electronic signature legislation seems to be the most prudent. The number of electronic signature applications is growing, and the rate of technological change is increasing. If states develop broad statutory guidelines and designate an agency to develop regulations and maintain oversight, they can maintain flexibility while creating the legal foundation for electronic signature use. California and Texas are both excellent models. The California statute gives the appropriate authority to the Secretary of State, while the Texas statute gives it to the General Services Commission.

The Utah technology-specific model has lost favor among most policy makers. Although currently digital signature technology is the most effective in terms of security and efficient verifiability, it has its shortcomings, such as the lack of CAs, and may not be the technology of the future. Laws that acknowledge only digital signatures risk becoming outdated and can inhibit the development of the electronic authentication market. Nevertheless, this does not suggest that governments should not work to build a public key infrastructure. The federal ACES program will build the PKI needed for all forms of EC. Governments can develop technology-neutral laws while providing the needed support for a PKI.

The scope of applicability in electronic signature laws is a difficult policy question, because until the laws are tested in court, many users (and potential users) of electronic signatures will have concerns about signature validity. The California approach of limited applicability is inefficient, because expanding the scope of their EC initiatives requires passing new legislation. Nevertheless, the Utah approach has risks, because if two private entities make a contractual agreement online, the courts may nullify it. It is unlikely, though, that the judicial branch would find that digital signatures do not have the same force and effect as manual signatures. The Uniform Commercial Code already holds that a signature need be nothing more than a mark intended by the person making it to be a signature.[40] Therefore, passing broadly applicable legislation would encourage the use of electronic signatures and support EC.

Once the federal initiative, ACES, is implemented, states should no longer have to consider becoming a CA. States could avoid the significant costs and liability risks associated with becoming a CA; most of the states that have authorized agencies to act as CAs have done so because no private CA existed. Instead of creating a new infrastructure, states should rely on the ACES program.

The current trend appears to be for states to address liability issues through legislation. The Illinois Electronic Commerce Security Act, signed in August 1998, is an excellent model.[41] Most states that have seriously considered electronic signatures have created statutes to penalize the CA for abuse or neglect, to state explicitly that existing laws pertaining to fraud apply to digital signatures, and to establish a legal presumption that the individual identified on the certificate was the sender of the document.

If the legal foundation supporting electronic signatures is established and policy makers overcome the

other challenges to EC, the effect of EC initiatives will be pervasive. Long lines at government offices will be an experience of the past. Government employees will spend less time doing mundane data entry tasks, and more time working directly for the public. Procurement processes will be streamlined to maximize the use of taxpayer dollars. The potential for corruption will be minimized. Governments will have new sources of revenue. Citizens will have instant access to public services. The public perception of government will change from slow, wasteful and ineffectual, to efficient, flexible and taxpayer-oriented. If policy makers take full advantage of EC and digital signatures, the public will witness nothing short of a renaissance in government.

LBJ

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Insurance Redlining in Texas?

On July 23, 1967 the city of Detroit, Michigan erupted into flames due to a race riot. Within five days of rioting 40 people were dead, 2,250 injured, and $250 million worth of homes and businesses were destroyed.[1] Detroit was not the only American city to witness mass urban havoc during the summer of 1967. New York, Chicago, Newark, Memphis, Cincinnati, and Cleveland also endured race riots. Before the summer was over, nearly 70 American cities were subject to urban revolt.[2]

Five days after the Detroit riot began, President Lyndon Baines Johnson (LBJ) addressed the nation about the recent scenes of violence that had swept the nation's streets. The President began his speech by announcing that he had created a special Advisory Commission on Civil Disorders to examine the questions of how, and more importantly why, the riots happened.[3] But LBJ also had other questions on his mind. He understood that the riots did not materialize out of nothing; the more substantive explanation for their occurrence lay within the inequities that plagued America's inner-cities. LBJ charged the newly appointed Advisory Commission with examining precisely what these inequities were and how they came to be.

President Johnson recognized that much rebuilding needed to be done in the wake of the riots that were sweeping the nation. The riots destroyed millions of dollars worth of homes and businesses. Concerned about the cost of rebuilding efforts, he contemplated, "[w]hat is the proper public role in helping cities repair the damage that has been done?"[4] Moreover, LBJ wondered how innocent homeowners and business owners alike

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could be financially protected in the event of another widespread calamity. To this end he asked, "[w]hat can be done to help innocent people and vital institutions escape serious injury?"[5] These questions pointed toward a particular problem that was symptomatic of the urban malaise within the nation's cities: the widespread absence of insurance coverage. The Advisory Commission felt that the insurance availability issue was too big and complex for it alone to address. President Johnson agreed, and quickly formed the National Advisory Panel on Insurance in Riot-Affected Areas to focus exclusively on the need for insurance coverage within America's inner cities.[6]

The Advisory Panel on Insurance in Riot-Affected Areas published its findings six months after the Detroit riots began. The Panel's research was one of the first attempts to survey racial discrimination in the homeowners insurance market. Its findings were simple: "A great deal of evidence confirms that there is a serious lack of property insurance in our nation's inner cities."[7] Insurance companies generally refused to underwrite policies within inner-city neighborhoods. If insurance was available, the Panel found that the price for these insurance policies was relatively high.[8] These conclusions would resonate in similar studies on the availability of homeowners insurance conducted over the next three decades.

"Since the time that the Advisory Panel published its report a debate has persisted between fair housing and consumer advocates and the insurance industry over the existence of unfair discrimination in the homeowners insurance market. During the 1970's and 1980's the advocates were, for the most part, correct. The insurance industry, in general, did discriminate against minority neighborhoods."

Since the time that the Advisory Panel published its report a debate has persisted between fair housing and consumer advocates and the insurance industry over the existence of unfair discrimination in the homeowners insurance market. During the 1970's and 1980's the advocates were, for the most part, correct. The insurance industry, in general, did discriminate against minority neighborhoods. Discrimination by the insurance industry contributed to a widespread absence of insurance coverage within minority neighborhoods. This, coupled with the lack of financial investment from lending institutions, contributed to a larger problem known as disinvestment. In the absence of the financial resources necessary for growth and development, minority communities suffered from depression, depreciating property values, and blight.

Today, however, identifying the "right" side to this debate has become more of a challenge. Statutory and industry-based reforms worked to correct past forms of discriminatory practices. Nevertheless, advocates still argue that the insurance industry uses underwriting guidelines that have a disparate impact on minority neighborhoods. The insurance industry counter-argues that it no longer discriminates, and that minority neighborhoods do not face an availability problem with regards to homeowners insurance coverage. Each side makes valid claims that are substantiated by facts. Consequently, the issue of whether discrimination persists in Texas' homeowners insurance market is ambiguous.

THE NECESSITY OF HOMEOWNERS INSURANCE

Insurance, by definition, represents a guarantee from loss or harm. Insurance policies sold by insurance companies mitigate the risk of losing an asset, or assets, in the event of an unforeseen disaster. Car insurance prevents an individual's investment in an automobile from being lost in a wreck. Homeowners insurance guarantees an individual's home and property from the losses caused by fire, natural disaster, or crime. The function of an insurance policy, be it for a home or an auto, is the financial and psychological security that it provides. This element of security, in turn, fosters investment in larger assets such as homes, cars, and business enterprises.

Homeowners insurance is a critical requirement for accessing sufficient capital to purchase a home or business. The ability to access homeowners insurance secures the necessary backing from banks for investment in homeownership, business and commercial development, and urban redevelopment.[9] More specifically, lending institutions such as banks only give mortgage loans to properties that are underwritten by an insurance policy. Insurance coverage provides security for a lending institution's loan in the event that the capital asset, for which the loan is intended, is destroyed. Consequently, the lending institution does not risk losing its investment in the loan.

The benefits of insurance go beyond the promotion

of capital investment within a community. In the long run, homeowners insurance promotes communities' economic stability and development. In addition, since insurance is requisite for mortgage financing, it promotes the maintenance of quality of life within a neighborhood and the preservation of property values. These features, in turn, suggest that insurance serves as one of the bulwarks against urban blight and its trappings of crime, depreciating property value, and unemployment. Communities without insurance are challenged to survive. The President's National Advisory Panel of Insurance in Riot-Affected Areas observed this phenomenon in 1968:

> Without insurance, banks and other financial institutions will not—and cannot—make loans. New housing cannot be constructed, and existing housing cannot be repaired. New businesses cannot be opened, and existing businesses cannot expand, or even survive. Without insurance, buildings are left to deteriorate; services, goods, and jobs diminish. Efforts to rebuild our nation's inner cities cannot move forward. Communities without insurance are communities without hope.[10]

Invariably, homeowners insurance serves a crucial function for all American communities. Insurance helps communities grow, develop, and stabilize. In the absence of insurance coverage, communities are left to rot, unable to overcome the poverty associated with disinvestment.

The absence of insurance within minority neighborhoods presents three public policy problems in the areas of fair housing, economic opportunity, and racial segregation. Racial minorities living within redlined neighborhoods face barriers to reaching their goal of homeownership; the absence of insurance coverage precludes their ability to obtain mortgages and home improvement loans.[11] While aspiring homeowners in non-redlined areas may reach their goal, others are categorically denied on account of insurance redlining. Second, those with access to insurance have greater opportunities to secure the requisite financing for capital investments than those who live in redlined areas. Last, the absence of insurance in certain areas, particularly low-income, minority neighborhoods, works to exacerbate the problems of racial segregation in housing markets and the concentration of poverty within inner-cities.[12]

Discrimination, Underwriting, and Insurance Coverage

Insurance redlining occurs when companies discriminate against a class of consumers on the basis of factors beyond the consumers' control.[13] The business of insurance is, however, discriminatory by nature. Each insurance company provides insurance policies at a price to cover costs and provide a competitive rate of return.[14] In short, the objective of insurance companies is to make an annual profit. The greater the risk involved with an insurance policy, the greater the likelihood that the policy might, in the long run, prove unprofitable for the insurance company. Alternatively, the lower the relative risk involved with a policy, the greater the likelihood that it will be profitable for the underwriting company. Consequently, insurers try to discriminate against high-risk, and potentially unprofitable, applicants in favor of those with a lower relative risk.

Insurance companies determine whether or not to accept an applicant for insurance coverage through a process known as underwriting. During the underwriting process a series of rules, known as underwriting guidelines, are used to determine whether an applicant's relative risk is acceptable. Underwriting guidelines also determine how much of a premium, or policy price, an accepted applicant will be required to pay. As a rule of thumb, the higher the rate of acceptable risk, the higher the expected premium.

Each insurance company uses its own set of underwriting guidelines. The written guidelines themselves range from being specific and objective about certain criteria to being broad and subjective.[15] Although underwriting guidelines have a widespread effect on the availability of homeowners insurance, they are not available for public review in most states. The insurance industry claims, as it has successfully done in court, that the guidelines are confidential trade secrets.[16]

Questions concerning fair underwriting practices do not focus exclusively on whether they are discriminatory. Rather, questions concerning fair underwriting focus on whether the underwriting guidelines used are objective, reasonable indices for measuring risk. Refusing to underwrite a house built on a flood plain, on a beach susceptible to hurricanes, or on a mountain slope subject to avalanches may, in some cases, be considered reasonable. Refusing to underwrite an insurance policy for a well-built home occupied by a black family on grounds that the occupants are black, however, is not.

FROM RED LINES TO ANTI-DISCRIMINATION: A BRIEF HISTORY OF REDLINING IN AMERICA

In 1967 questions regarding discrimination by homeowners insurance underwriters were arguably easier to answer than they are now. Then, insurance companies actively engaged in redlining, or unfair discrimination, against neighborhoods on the basis of their racial composition.[17] The Advisory Panel's report observed this particular phenomenon. It found that one insurance company recommended "*the use of a red line* around the questionable areas on territorial maps" as a way to readily delineate undesirable, or predominantly minority populated, neighborhoods (report's italics).[18] One insurance agent told the Panel that companies refer to minority neighborhoods as "red line districts" or "knock-out areas" where business was simply not encouraged.[19] At the time that the Advisory Panel published its report, and for some years afterwards, insurance companies associated the race of the homeowner with the relative risk of the transaction. Then, it was assumed that minority homeowners were an inherently greater risk by virtue of their status as a racial minority.

Examples of the outright use of discriminatory racial classifications by the insurance industry abound. In 1958 the National Inspection Company urged underwriters to exercise considerable scrutiny "in the case of Negro dwellings."[20] Nearly twenty years later an official with the New York Department of Insurance observed that the black residents of Harlem "don't need insurance because they don't have anything of value to insure."[21] As a result, it was considered reasonable for insurance companies to claim that they had no obligation to underwrite insurance policies in black neighborhoods. Another instance of the use of race as a reason to deny insurance policies to minorities occurred in 1986. Then, a representative with the American Family Insurance Group told an agent, "Very honestly, I think you write too many blacks . . . we cannot afford them . . . You got to sell good, solid premium-paying white people."[22]

Policies and attitudes have changed over the past few decades. The Federal Fair Housing Act of 1968, which arguably prohibits discrimination in the homeowners insurance market, prompted companies to amend their earlier underwriting methods.[23] Insurance companies such as State Farm, Allstate, Aetna, and Travellers have signed commitments of non-discrimination.[24] Aetna even went so far as to publish an advertisement in national magazines during the 1980's depicting a man eating a crow as an admission of its past discriminatory practices.[25] Now, insurance companies underwrite policies through the use of objective underwriting, also known as risk-rating, criteria. The use of these criteria, the companies claim, permits for equitable access to homeowners insurance coverage. Despite the industry's claims, however, a host of contemporary studies conclude that the incidence of insurance availability decreases in neighborhoods with high minority populations. These studies suggest that although the use of a red line on a city map is no longer the accepted practice, the underwriting guidelines used by insurance companies still work to preclude minority communities' access to homeowners insurance coverage.

UNFAIR UNDERWRITING IN TEXAS?

Litigation, legislation, and social activism worked to correct the industry's blatant use of race as a criterion for rating risk. Now, some believe that insurance companies use less obvious discriminatory techniques in their underwriting practices. Although racial classifications are no longer used for underwriting purposes, minority communities do not have unabridged access to homeowners insurance. Consumer and fair housing advocates point out that insurance companies use underwriting criteria that still have a disparate impact on minorities' ability to access homeowners insurance. For example, many insurers require homes to be worth at least $50,000 in order for applicants to qualify for coverage.[26] This requirement has an adverse effect on black homeowners, 42 percent of whom live in homes valued under $50,000.[27] Some insurers also require that homes not be older than 20, 30, or 40 years old.[28] This requirement also disproportionately affects minority communities: the average age of homes in minority communities is greater than that for the average American home.

A 1997 study of underwriting guidelines by the Texas Office of Public Insurance Counsel (OPIC) found that 88 percent of the state's insurers denied coverage based on a home's value, while 56 percent denied coverage on the basis of age.[29] The State of Texas, however, has worked to correct these practices. In 1997 the Texas Department of Insurance adopted a regulation prohibiting the use of age and minimum value requirements.[30] Both requirements were perceived by the State as a form of "lazy underwriting" because they were too broad to be considered reasonable determinants of risk.[31] The restrictions on age and value requirements were intended to force insurance companies to look at more specific risk factors, such as the actual condition of a home's premises.[32]

The age and value of a home are not the only un-

derwriting criteria that have a disparate impact on minority homeowners. Historically, insurers have denied coverage on the basis of a household's location. Location restrictions are usually vague and without any objective standards.[33] In general, location restrictions discriminate against homes located near commercial property or in neighborhoods with high crime rates or declining property values.[34] Location restrictions for homeowners insurance feed on prejudices of inner-city neighborhoods and serve as a ready alibi for insurers to hide intentional discrimination.[35] The 1997 study by OPIC found that 56 percent of insurers use location restrictions.[36]

Other underwriting criteria that work to redline minority neighborhoods are requirements for a homeowner's lifestyle, credit history, and marital status.[37] Lifestyle requirements exclude families, friends, or groups that live in the same dwelling and are not related by marriage or blood.[38] Lifestyle requirements also include the subjective measure of an applicant's character. Underwriting guidelines with these requirements favor homeowners with "high moral standards" or "moral character above reproach" and shun those with "bad morals" or a "defect in character."[39] Credit history requirements discriminate against applicants with bad credit. A poor credit rating reduces the likelihood that an applicant will have the financial capacity to maintain their home, much less be able to afford expensive premium payments.[40] Marital status requirements are similar to those for lifestyle. In particular, marital status requirements discriminate against single or divorced applicants.[41] OPIC's study found that 26 percent of insurers use lifestyle requirements, 35 percent use credit history, and none use marital status (pursuant to a TDI prohibition).[42] Race is no longer a criterion for insurance underwriting per se. Nevertheless, consumer and fair housing advocates point out that underwriting criteria such as credit history, age of home, and location requirements serve as surrogates for race.

The Disparate Impact in Texas

In 1994, OPIC published a report on the disparate impact of discriminatory underwriting practices in Texas.[43] The report found that in Austin, "the greater the minority population of a zip code, the less likely that an owner-occupied home in that zip code will be covered by standard homeowners insurance."[44] In Fort Worth it was found that "[a]s the percentage of nonanglos increases [within certain zip codes], the level of homeowners insurance coverage decreases *exponentially*" (report's italics).[45] Similar conclusions were reached in Dallas, Houston, Lubbock, and San Antonio. In each city, standard insurance companies underwrote fewer policies in minority areas than they did in non-minority ones.

The absence of coverage by standard insurance companies does not necessarily mean that communities suffer from a complete lack of coverage. OPIC's report observed that homeowners could still purchase less desirable policies that covered only fire damage and not other risks such as water damage, theft, or liability.[46] In addition, if standard companies do not write a policy for an applicant they consider high-risk, then another type of insurance company, known as a surplus lines carrier, will provide coverage at a higher rate. The prevalence of surplus lines coverage is problematic. It is more expensive than coverage offered by a standard carrier. In addition, surplus lines coverage is not solvency regulated; there is no legal guarantee that the company will have the funds available to pay damage claims. Standard carriers, however, are solvency regulated, and thereby less risky to a policyholder needing to file a claim. Interviews with independent insurance agents who underwrite in Austin's minority neighborhoods revealed that a greater proportion of surplus lines policies are written in those areas than elsewhere within the city.[47] The prevalence of surplus lines carriers in minority neighborhoods suggests that standard companies have chosen not to establish markets in these areas.

The Case for the Industry's Claim of Non-Discrimination

The evidence of racial discrimination by insurance companies appears convincing. Standard, preferred companies underwrite fewer insurance policies in minority neighborhoods than in non-minority areas. There are, however, a number of explanations for this phenomenon other than the claim that the insurance industry discriminates against minority neighborhoods. The first explanation, which is the most widely used by insurers, is that companies use fair, objective underwriting criteria. The fact that standard insurance companies underwrite less insurance in minority neighborhoods is not reflective of the use of intentionally discriminatory criteria. The underwriting guidelines for one national insurance company state:

1. In no case will homeowners insurance be denied because of age, sex, race, religion, or marital status of the owner or the resident of the dwelling.
2. No request for homeowners insurance will be

> denied and no policy cancelled or non-renewed because of age or location of a residence, type of construction (brick or frame), or because another insurer declined insurance.[48]

Other companies also maintain that age, value, or the location of a home are not factors in their underwriting.[49] In addition, statutory prohibitions on the use of certain criteria, such as the State of Texas' ban on the use of age and value of a home, have engendered the use of more equitable underwriting.

Insurers contend that their underwriting guidelines are not to blame for the disparate impact in rates of coverage. Rather, they argue that the actual quality of the homes limits their ability to provide coverage. An Austin insurance agent noted that the physical conditions of many homes in low-income, minority areas tend to be of a lower quality.[50] The high incidence of old roofs and electrical and plumbing systems, which are inherently risky, tend to discourage standard companies from underwriting in such areas.[51] In addition to the poor conditions of the homes themselves, the agent also observed that high theft rates were also a deterrent. Another agent pointed out that these high-risk homes could usually be placed under a more expensive surplus lines policy.[52]

Alternative Explanations for a Disparate Impact: Income and Education Constraints

Low-income homeowners' microeconomic preferences may affect the availability of insurance in minority neighborhoods. Homeowners insurance is expensive. In Travis County, the cost of a homeowners insurance policy can range between $370 to $730 annually depending on the type of home.[53] Invariably the absolute price of homeowners insurance coverage is expensive for any homeowner, but it is particularly more costly for lower income homeowners. For some low-income households the prospect of paying upwards of $400 to $600 for a homeowners insurance policy is hard to justify, particularly if they cannot afford such necessities as food, clothing, bills, and medicine.

The problem of an un-informed consumer may contribute to a disparate impact in low-income areas. A representative with State Farm Insurance Companies observed that consumers do not know very much about insurance.[54] Some homeowners understand that a homeowners insurance policy is necessary for maintaining a mortgage, yet fail to realize the continuing value of keeping a policy once the mortgage is paid-off. In addition, consumers in low-income, minority neighborhoods may not know that standard insurance companies are "out there," willing to underwrite almost any homeowner with an insurable home. The industry's past history of refusing to underwrite in minority neighborhoods may fuel this impression. In some instances, standard companies are willing to underwrite anywhere, yet consumers' ignorance of both this fact and of the salience of insurance coverage gets in the way.

The explanations given above provide alternative reasons for why minority neighborhoods have less insurance coverage than do non-minority ones. The problem of equitable access to insurance may be less a manifestation of racial discrimination and more a complication of inequities in income and consumer education. The recent history of the Texas Department of Insurance Market Assistance Program suggests that these explanations may be true.

The Quandary of the Market Assistance Program

In 1995, the Texas State Legislature addressed the issue of homeowners insurance redlining. The Market Assistance Program (MAP) was created during this session as a measure designed to combat the perceived problem of discrimination in the homeowners insurance market. Two years later the program was initiated for public use.

MAP is designed to increase the availability of homeowners insurance to homeowners in certain designated underserved areas. The program's objective is to guide homeowners without insurance, or with policies with surplus lines carriers, towards policies underwritten by standard, preferred carriers. Homeowners seeking assistance through the MAP must meet five eligibility requirements.[55] First, a homeowner's property must be in good physical condition. Second, a homeowner cannot have a history of making fraudulent insurance claims. Third, a homeowner cannot have been previously cancelled from the MAP on account of prior unpaid premiums. Fourth, an applicant must have written verification of having been rejected by at least two unaffiliated standard companies (such as State Farm, Farmers, or Aetna). Last, a homeowner must live in a ZIP-code area that has been designated as "underserved" by the Texas Department of Insurance. The underserved Texas ZIP-codes were designated by TDI in 1996. The criteria for the underserved designation included low median household income, low median value of owner-occupied homes, older median age of homes, high theft losses per policy, and a high number of

surplus lines policies.[56] A total of 427 Texas ZIP-codes were designated as underserved by the time the MAP began.[57]

When the Texas State Legislature introduced the MAP, they assumed that response to the program would be substantial if underserved areas did not have access to insurance. The popular response to the MAP, however, has not been as great as originally anticipated. As of January 1999, only 213 eligible homeowners had applied for assistance through the MAP.[58] Of those 213 applicants, only 35 had accepted homeowners insurance policies offered by companies participating in the program.[59]

There are two possible explanations for the lackluster response to the MAP. First, homeowners in underserved ZIP-codes may not know of the program and its intention. The absence of public education about the MAP may be symptomatic of the uninformed consumer. Second, the problem that the MAP was designed to correct, that of an absence of available homeowners insurance in underserved areas, may not exist. Insurers argue that the brief history of the MAP vindicates their claim of using fair, non-discriminatory underwriting guidelines.

CONCLUSION

Answers to the redlining debate are not readily clear. Advocates' cries of discrimination are met by the industry's claim of the use of fair underwriting criteria. Governmental efforts to combat the problems of insurance availability, as seen in the case of the MAP, suffer from a lack of popular response. In the meantime, America's cities continue to crumble under the weights of blight and disinvestment. This point was made painfully clear to the nation during the Los Angeles riots in 1991.

The evidence presented suggests that there is a shortage of insurance coverage in minority neighborhoods. This problem could be mitigated through the adoption of aggressive educational outreach programs on the insurance industry's behalf. One company, State Farm, has already taken measures to aggressively market within underserved areas in Texas.[60] Over the past five years, State Farm has opened "Full Service Offices" in underserved areas in Houston, Austin, San Antonio, and Dallas.[61] Company representatives also attend housing fairs to educate potential homeowners about the virtues of homeowners insurance coverage.[62]

Education, however, can only go so far to ameliorate the problems facing some urban minority communities. It cannot make $400 insurance premiums affordable for homeowners with annual incomes below the poverty level. Nor can it repair the dilapidated homes in which some cash-strapped homeowners live. These inequities in income and housing conditions, among others, are symptomatic of a problem larger than that of insurance redlining.

Many urban communities suffer from disinvestment, or the consistent absence of the resources necessary for growth and vitality. The American historical experience of institutional racism has played a critical role in creating this situation. The race-based redlining once used by insurance companies and lending institutions has created an enduring legacy of inequality. The contemporary prevalence of substandard housing, low household incomes, depreciating property values, and other manifestations of urban blight within minority neighborhoods originate from the racially discriminatory practices of the past. Disinvestment, in turn, engenders market failures where certain industries are precluded from entering a certain area. The fault for these market failures, however, does not lie with those who suffer from them, but from the inequitable practices of the past.

The presence of a market failure, particularly in an area relative to public policy, warrants the consideration of solutions. Government-based solutions are justified in the absence of market-based self-correcting actions. Governmental efforts to improve the quality of housing in underserved areas could help some applicants meet the underwriting guidelines of some standard insurance companies. Neighborhood revitalization efforts, such as the construction of affordable housing, the creation of business enterprise zones, and area beautification programs could help stabilize depreciating property values and allay certain risks within blighted areas. In addition, attempts to create livable wages could work to make insurance premiums more affordable for lower income homeowners.

Whether or not solutions like these will work is subject to debate. The Great Society envisioned by President Johnson was an attempt to cure some of the ailments of disinvestment that he understood to plague America's inner-cities. Some say his efforts and vision were successful to a certain degree. Others charge him with outright failure. Nevertheless, LBJ had the right idea: the problems of the inner-city, the ones that spawned the riots of 1967, had to be solved if the viscous cycle of disinvestment were ever to be overcome.

LBJ

NOTES

1. Joseph Boskin, *Urban Racial Violence in the Twentieth Century,* 2nd Ed. (Beverly Hills, CA: Glencoe Press, 1976), p. 132.
2. Ibid., p. 133.
3. National Advisory Commission on Civil Disorders, *Report of the National Advisory Commission on Civil Disorders* (Washington, D.C., March 1, 1968), p. 296.
4. Ibid.
5. Ibid.
6. President's National Advisory Panel on Insurance in Riot-Affected Areas, *Meeting the Insurance Crisis of Our Cities* (Washington, D.C., January 1968), p. ii.
7. Ibid., p. 2.
8. Ibid., p. 3.
9. Gregory Squires, *Insurance Redlining: Disinvestment, Reinvestment, and the Evolving Role of Financial Institutions,* Gregory Squires, ed. (Washington, D.C.: The Urban Institute Press, 1997) p. 3.
10. President's National Advisory Panel on Insurance in Riot-Affected Areas, *Meeting the Insurance Crisis of Our Cities,* p. 2.
11. Squires, *Insurance Redlining,* p. 5.
12. Ibid.
13. U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, "The Availability, Affordability, and Accessibility of Homeowners' Insurance, Particularly in Urban Neighborhoods," testimony by J. Robert Hunter, May 11, 1994.
14. Robert Klein, *Race, Ethnicity and Auto Insurance in Texas: An Evaluation of CEJ and OPIC Reports* (Atlanta: Center for Risk Management and Insurance Research, December 3, 1997), p. 4.
15. D.J. Powers, "The Discriminatory Effects of Insurance Underwriting Guidelines," in *Insurance Redlining: Disinvestment, Reinvestment, and the Evolving Role of Financial Institutions,* ed. Gregory D. Squires (Washington, D.C.: The Urban Institute Press, 1997), p. 120.
16. Ibid., p. 121.
17. The term "redlining" is derived from the practice of delineating a red line on city maps to denote those areas that consisted of predominantly minority populations. Those areas located within red lines were considered high or unacceptable risks.
18. President's National Advisory Panel on Insurance in Riot-Affected Areas, *Meeting the Insurance Crisis of Our Cities,* p. 6.
19. Ibid.
20. Gregory Squires, "Race Politics, and the Law: Recurring Themes in the Insurance Redlining Debate," in *Insurance Redlining: Disinvestment, Reinvestment, and the Evolving Role of Financial Institutions,* p. 7.
21. Ibid.
22. William Lynch, "NAACP v. American Family," in *Insurance Redlining: Disinvestment, Reinvestment, and the Evolving Role of Financial Institutions,* ed. Gregory D. Squires (Washington, D.C.: The Urban Institute Press, 1997), p. 159.
23. Stephen Dane, "Application of the Federal Fair Housing Act to Homeowners Insurance," in *Insurance Redlining: Disinvestment, Reinvestment, and the Evolving Role of Financial Institutions,* ed. Gregory D. Squires (Washington, D.C.: The Urban Institute Press, 1997), p. 3.
24. U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, "The Availability, Affordability, and Accessibility of Homeowners' Insurance, Particularly in Urban Neighborhoods," testimony by William R. Tisdale, May 11, 1994.
25. Ibid.
26. Powers, "Discriminatory Effects," p. 126.
27. Ibid.
28. Ibid.
29. Office of Public Insurance Council (OPIC), *Selected Residential Property Insurance Underwriting Guidelines* (Austin, Tex., December 1997), p. 2.
30. Ibid.
31. Interview with Rod Bordelon, Public Counsel, Office of Public Insurance Counsel, Austin, Texas, March 4, 1999.
32. Ibid.
33. Powers, "Discriminatory Effects," p. 127.
34. OPIC, *Selected Residential Property Insurance Underwriting Guidelines,* p. 2.
35. Powers, *Insurance Redlining,* p. 128.
36. OPIC, *Selected Residential Property Insurance Underwriting Guidelines,* p. 2.
37. Powers, "Discriminatory Effects," pp. 129-132.
38. Ibid., p. 129.
39. Ibid., p. 130.
40. Interview with Robert "Bo" Gilbert, Director of Governmental Relations, Texas Association of Independent Insurance Agents, Austin, Texas, January 21, 1999.
41. Powers, "Discriminatory Effects," p. 132.
42. OPIC, *Selected Residential Property Insurance Underwriting Guidelines,* p. 2.
43. A number of studies conducted over the past decade throughout the nation suggest that the availability of homeowners insurance is less prevalent in minority neighborhoods than in non-minority ones. For example, a study by the Missouri Department of Insurance in

1993 revealed that the state's twenty largest insurers concentrated their sales in predominantly white ZIP codes (Arlene Zarembka, "Time to Erase Red Lines," *St. Louis Post Dispatch* (April 28, 1993), p. 3C.) The study also found that homeowners in low-income white neighborhoods are more likely to get insurance than homeowners in low-income black neighborhoods. Missouri's Department of Insurance also found a striking discrepancy in the price of insurance policies offered. Homeowners in predominantly minority neighborhoods paid an average of $6.15 in premiums per $1,000 of coverage whereas homeowners in non-minority areas paid $4.70 per $1,000. (Gregory Squires, "Insuring a Neighborhood's Stability," *Chicago Tribune* [November 13 1993], p. 25N.) Another study on insurance availability in Minnesota's Twin Cities by the Association of Community Organizations for Reform Now (ACORN) in 1994 found that 47.5 percent of homes in low-income black communities were insured compared to 79.8 percent in white suburbs. (Willard Woods, "State Finds Little Proof of Insurance Redlining," *Star Tribune* [March 9, 1994], 1B.) A subsequent study by the National Association of Insurance Commissioners (NAIC) found that insurers wrote fewer policies and charged higher premiums in black communities than in white ones. (Gregory Squires, "Dark Past, Bright Future," *Chicago Sun Times* [March 21, 1996], p. 24.) The findings of the NAIC study were consistent in all 47 cities that were surveyed. More interestingly, the NAIC studied neighborhoods where the objective rate of risk and other socio-economic characteristics were the same. See OPIC, *Selected Residential Property Insurance Underwriting Guidelines*.

44. Office of Public Insurance Counsel (OPIC), *Insurance Redlining in Texas A Preliminary Report* (Austin, Tex., August 29, 1994), p. 5.
45. Ibid., p. 9.
46. Ibid., p. 2.
47. Interview with Sterling Sasser, President, Sasser and Sons Insurance Agency, Austin, Texas, March 2, 1999; Interview with Shirrell Hipp, Insurance Agent, Hipp Insurance, Austin, Texas, February 23, 1999.
48. State Farm Insurance Companies, *Efforts to Enhance Insurance Availability in Low and Moderate Income Areas of Texas,* n.d., (pamphlet).
49. Gilbert interview.
50. Sasser interview.
51. Ibid.
52. Hipp interview.
53. Texas Department of Insurance, *1988 Homeowners Insurance Rate Guide Central Texas,* Austin, Texas n.d., (brochure).
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55. Interview with Kathy Graf, Supervisor, Market Insurance Program, Texas Department of Insurance, Austin, Texas, February 3, 1999.
56. Texas Department of Insurance Market Assistant Program, *MAP, PPP, VIP: Sampling the New Insurance Alphabet Soup* (Austin, Tex., Fall 1996), pp. 2-3.
57. "1-888 Number to Help Homeowners Find Insurance," Texas Department of Insurance Public Information Office, July 1, 1997 (press release).
58. Texas Department of Insurance Market Assistance Program, Participating Insurers MAP Report, Cumulative Applicant Information (Austin, Tex., January 12, 1999), p. 3.
59. Ibid. An even larger number of eligible applicants received quotes from companies willing to provide them with homeowners insurance policies. Although given a quote, these homeowners elected to not accept the policies offered.
60. State Farm Insurance Companies, *Efforts to Enhance Insurance Availability in Low and Moderate Income Areas of Texas,* n.d., (pamphlet).
61. Ibid.
62. Bullock, Mueller, Ruggiero, Salinas, Sager interview.

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One Europe = One Currency:

Prospects and Perils of European Economic and Monetary Union

by Tomasz A. Swinarski

Tomasz A. Swinarski is a Polish student in a three-year, joint degree Master's program in public affairs and business administration. This article is based on a research paper prepared for Professor Bill Black's class, "Advanced Topics in Public Financial Management and Regulations," and submitted (coincidentally) on May 9, 1998—the Europe Day. Prior to his studies at The University of Texas at Austin, he received a Master of Science in Environmental Engineering in 1997 from the Cracow University of Technology, Kraków, Poland. Tomasz's accomplishments include repeatedly winning the Polish Champion in Mountain Triathlon title, leadership of several exploratory expeditions, and photographic exhibitions and awards.

There are certain gains resulting from the use of a single currency. Try to imagine the United States with each state having its own bank, issuing its own currency, and pursuing its own monetary policy. The most relevant advantages of a single currency include price transparency allowing instant comparisons, no exchange rate risk and currency exchange costs, and improved capital mobility.

Europe, however, is not a single country. There are 15 nations in the European Union (E.U.)[1] with several others preparing for entry into the Union. On January 1, 1999, eleven countries joined the Monetary Union; effectively and legally, the national currencies of the participating countries ceased to exist as national currencies and became the euro, the currency to be used throughout the E.U. Until recently, each nation had its own distinct monetary policies and regulations governed by different central banks, as well as different currencies. Since the beginning of 1999, these countries have all shared the same currency and the same common bank.

The quest for European financial coordination has a half-century of history. Encouraged by the vision of all the advantages of a single currency, the European Economic Community tried to attain many of these advantages via semi- or quasi-fixed exchange-rate schemes where small fluctuations between currencies were allowed. Unfortunately, this approach proved utopian. With different monetary and fiscal policies, the relative prices of key currencies diverged reflecting different dynamics of the national economies, and each European currency system failed. Therefore, a more radical solution is on its way to final implementation—the Economic and Monetary Union (EMU)—a single shared currency, the

euro, and one common central bank, the European Central Bank, and a limited scope of freedom for fiscal policies.

This homogenization of monetary (and partially fiscal) Western European policy is a pioneer challenge on an unheard-of scale. The benefits of sharing a common currency come at certain costs, such as restrictions on national deficits and loss of freedom to independently set short-term interest rates. These apparent tradeoffs create a risk, that due to the inability to respond to certain adverse conditions in an adequate manner, the new economic system may become unstable. Two major problems have emerged. One is the transition itself. The second is the system's behavior in case of asymmetric shocks. (An asymmetric shock may be any major economic event that affects involved parties unequally. It stems from inherent dissimilarities between nations' economies, and thus disrupts their relative balance.) In order to reduce the exposure to that risk, two sets of actions are necessary: 1) minimize a probability that predicaments arise, and 2) maximize the system's capacity to absorb and neutralize distortions. Radical separation of the European Central Bank from sources of entirely undesired political influence is necessary to partially address the first issue. The second can be offset to some extent by increased labor mobility, the single most important and "natural" adjustment mechanism. These two measures should be complemented with intense removal of remaining structural differences between EMU-basket countries through extensive deregulation, and rapid alignment of social policies and tax regulations. This analysis concentrates on interactions between the eligibility requirements for entry into the EMU during "normal" economic stresses and in case of an asymmetric shock. The emphasis is on developing an adjustment mechanism to avoid crises.

"The infinitely short time span between the end of the year 1998 and the beginning of the year 1999 was one of the most important moments in the history of Europe."

FINAL COUNTDOWN: THREE . . ., TWO . . ., ONE . . ., . . . ?!?

As complex and multidimensional as it is, EMU perhaps should be recognized as a greater undertaking than the original founding of the European Economic Community (EEC), which began on March 25, 1957 with the Treaties of Rome signed by the Six[2] Member States: Belgium, France, Germany, Italy, Luxembourg, and The Netherlands.[3] Almost forty-two years later, on January 1, 1999, the final Third Stage of the EMU was launched, and eleven of the fifteen countries slated to enter the EMU joined the Monetary Union.[4] Denmark and the U.K. exercised opt-outs enabling them to stay outside of the euro area,[5] while Sweden and Greece[6] did not meet the convergence criteria, that is, they did not fulfill the necessary conditions for the adoption of a single currency.[7]

The infinitely short time span between the end of the year 1998 and the beginning of the year 1999 was one of the most important moments in the history of Europe. Two components of actual transition to the single currency were executed during that fraction of a twinkling of an eye. First, exchange rates between the EMU-basket currencies were replaced by irrevocably fixed bilateral conversion rates determined eight months in advance during May 1998 Summit.[8] Second, one ecu (an accounting unit established in 1979 as a weighted average of the national currencies of member states of a previous attempt at financial coordination, the European Monetary System) was converted into one euro. Since then, the national currencies of "Ins" countries have been merely expressions of the euro, and the Third Stage of the EMU was successfully deployed. (The term "Ins," as opposed to "Outs," refers to the E.U. countries that participate in the Monetary Union.) Effectively and legally, the national currencies of the participating countries ceased to exist as national currencies on December 31, 1998 at 11:59 p.m, and on January 1, 1999 at 12:00 a.m., they became euros with another (old and familiar) name retaining legal tender status within their countries of issue until July 1, 2002. For practical and political reasons, the issuance of euro currency is not scheduled to be introduced until January 1, 2002, so for the first two years of Stage Three it will exist in non-cash form only.[9]

The overnight switchover to euro was celebrated enthusiastically. Although some economists predicted an initially strong euro, anticipating that OPEC countries would rush to substitute part of their foreign currency reserves with euros,[10] within the first two and a half months the euro fell over 7.6 percent against the U.S. dollar. This trend has continued as of mid-March 1999.[11] Nonetheless, the London Stock Exchange jumped to a record high after the British government announced at the end of February 1999 its first cautious preparations for joining Europe's single currency early in the next century.[12]

PRICE OF CURRENCY AND CURRENCY RISK

No earlier attempt to peg European exchange rates withstood the real-life test, because the relative values of those currencies diverged substantially. Each currency has its price. If the price of a currency is not market determined, the demand-supply equilibrium has to be artificially reached by government actions. At times if the amount of a currency supply exceeds the amount demanded, the government through its central bank[13] has to buy the excess at the fixed-rate exchange. To pay for it, the country has to give up some of its foreign or gold reserves, or some combination of both, which occurs when a currency is overvalued, and as a result allows a balance-of-payments deficit. In a situation of this sort, there may be a "run" on the overvalued currency. Currency speculators may become convinced that the country with a balance-of-payments deficit cannot maintain the artificially high price of its currency much longer. Because they will suffer losses if they hold onto a currency that is devalued, the speculators are likely to sell the overvalued currency in very large amounts, thus causing an even bigger balance-of-payments deficit for that country. Faced with the exhaustion of its reserves, the country is likely to be forced to allow the price of its currency to fall.[14]

A country also may set an official artificially high price of its currency without supplying adequate amounts of foreign currencies that the market demands (as it was the case in all post-communist countries), but then a black market quickly develops. The reverse situation takes place when a currency is undervalued: by running a balance-of-payments surplus a country is increasing its reserves, and is unlikely and often resistant to increase the price of its currency, because then its exports would be more expensive, that is, less competitive. But how does the market determine the price of any given currency? This price is a result of a number of factors. Among the most important ones are current account deficit, foreign reserves, relative interest rates, government stability, perceived economic condition and its unique characteristics such as export and import patterns.[15]

The value of the American dollar, however, is much less dependent on these factors. This important feature is a characteristic of its role as the principal "global" currency. Perhaps one of the ultimate goals of the EMU's architects is the "globalization" of the euro. For this to happen, a sociological change in the way Europeans view their currencies is necessary. If this mindset is eventually achieved, it will substantially contribute to less volatility in European markets by exerting a stabilizing effect on prices. Benefits of low inflation are beyond dispute. Markets work more efficiently, the quality of savings and investment decisions improves, tax distortions are removed, and there is an end to the arbitrary redistribution of income that takes place through inflation.

In terms of its international weight, the euro is second only to the United States dollar. The Gross Domestic Product (GDP) of the eleven euro countries is roughly the same as America's. Their share of international trade is slightly bigger, and currently, their foreign-exchange reserves are much larger. The eleven euro countries' government bond markets, at current values, are worth over $2 trillion, only a little less than the U.S. The euro countries' combined equity markets are bigger than Japan's.[16] All this sounds very promising, but is the future of EMU really so bright and certain, and why are monetary unions so attractive?

PROS AND CONS OF THE EMU: OPTIMAL CURRENCY AREA

The theory of "optimal currency areas" was outlined by Robert Mundell, an American academic, in 1961. In essence, it states that there are certain gains from sharing a currency across borders: more transparent prices, lower costs, greater certainty for investors, and enhanced competition.[17] In the case of the E.U., these gains are estimated at 0.5percent of GDP.[18] Another benefit, especially appreciated by countries with poor inflation records, is price stability furnished by an independent central bank running a single monetary policy and committed to keeping inflation rates low. Unfortunately, each coin has its flip side. Negative consequences could be especially grave in cases of "asymmetric shocks." Countries that are in a recession often respond by increasing the growth of their monetary supplies, decreasing interest rates, and allowing their currencies to devalue in order to stimulate exports. These policies, however, are no longer available to states participating in the euro.

Optimal currency theory looks at alternative responses to such shocks, singling out three: 1) mobility of labor—workers in affected country must be able and willing to move freely to other counties, so there should be no cultural, linguistic or legal barriers; 2) flexibility of wages and prices—the country must be able to adjust these in response to a shock; and 3) some automatic mechanism for transferring fiscal resources to the affected country. The theory concludes that for a single currency area to have the best chance of success, asymmetric shocks should be rare, implying that cycles and structures of involved economies are alike.[19] Moreover, the single monetary

policy should affect all the constituent parts in the same way.[20]

It is obvious that none of these conditions are met in the E.U. Studies show that labor mobility is significantly lower between E.U. countries than within the U.S., reflecting the barriers created by, among other factors, language, culture, and differences in social security systems.[21] Nor does the E.U. officially encourage the idea of labor migration. The European Commission described regional mobility of labor as "neither feasible, at least not across language barriers, nor perhaps desirable."[22] In fact, however, labor mobility is limited between European countries as well as within them, but their own single national currencies work well, regardless of asymmetric shocks experienced by their economically diversified regions. The reunification of the FRG (Federal Republic of Germany or West Germany) and the GDR (German Democratic Republic or East Germany) on October 3, 1990, may serve as a counterexample; note, however, that unified Germany is in fact a new country experiencing a shock induced by the unification itself. Moreover, asymmetric shocks are more likely to hit industries or regions rather than countries.

"Most joblessness is structural as opposed to cyclical, i.e., it reflects over-regulated product and labor markets, rather than inadequate demand or tight fiscal policies. Due to predicted sharpened competition caused by the instant comparability in prices the euro will provide, industries are seeking methods for cutting their costs: merging with other firms, closing branches, shedding labor."

Under such circumstances the exchange rate is the wrong tool for making adjustments.[23] Considering that Europe is more diversified than some highly specialized regions of the U.S., it should also be more shock-resistant with respect to industry specific shocks. What's more, asymmetry was often induced by different fiscal and monetary policy measures aimed to counter shocks. The monetary part of this factor disappeared once the independent European Central Bank (ECB), modeled after the fiercely independent German *Bundesbank* that enforces its monetary policy irrespective of political pressure, became in charge of euro-policy on January 1, 1999.

The absence of fiscal transfers, however, is a more serious hurdle. Calculations in the 1980s suggested that, on average, 40 percent of any fall in gross state product (GSP) in the U.S. was compensated via higher benefits received from, or lower tax paid to, the federal government.[24] One new study, however, argues that currently the magnitude of this mechanism's intervention decreased four-fold in terms of percentage wise GSP.[25] Nonetheless, findings of the report of a Study Group under the chairmanship of the British economist Sir Donald MacDougall, published in 1977, should not be neglected. This report advocated a substantial expansion of the European budget up to 5-7 percent of Community GDP.[26] In the opinion of Alexandre Lamfalussy, the first European Monetary Institute (a precursor to the European Central Bank) president, if the E.U. budget is to play a stabilizing role, it has to be even bigger than that.[27] The Delors Report of 1989, produced to examine means of completing economic and monetary union, recognized that a central budget of this size was not politically feasible and referred instead to the need for "solidarity to iron out the economic difficulties or the surges in prosperity of individual states."[28] Writing in 1992, Sir Donald asserted his belief that the loss of exchange-rate adjustment would make essential larger transfers between Member States. He concluded: "I fear that an attempt to introduce monetary union without a much larger Community budget than at present would run the risk of setting back, rather than promoting, progress towards closer integration in Europe."[29] Any such increase, however, would be very controversial.

It is a big step for a national parliament to permanently hand over a proportion of its tax revenue to an outside body beyond its control. European Union governments are under pressure to cut public spending and taxes at home. The agreement to increase the size of the Community budget from 1.20 to 1.27 percent of combined GDP was accepted very reluctantly. In order to expand the EC budget, governments would have to further cut their expenses or increase taxes or do both at the same time. Considering that the EMU is extremely unpopular with many nations—in November 1997 up to approximately 60 percent in Finland and Denmark and 30 percent in the E.U. 15 Member States were against it—either alternative may lead to dramatic public discontent with fatal consequences for the EMU.[30] In Germany, a country with-

out which the EMU is hard to imagine, a majority opposes the EMU, and furthermore, Germany is demanding a reduction in the share of the E.U. budget it currently pays.[31]

The Community's overall unemployment rates of over 11 percent along with wage rigidity call for structural reforms.[32] Most joblessness is structural as opposed to cyclical, i.e., it reflects over-regulated product and labor markets, rather than inadequate demand or tight fiscal policies. Due to predicted sharpened competition caused by the instant comparability in prices the euro will provide, industries are seeking methods for cutting their costs: merging with other firms, closing branches, shedding labor.[33] Therefore, in the short run, the euro may increase unemployment. Increasing economic flexibility in other respects must compensate for the loss of monetary and fiscal policy independence. The way to reduce high unemployment is to deregulate labor-markets, trim welfare states, and cut wages and non-wage labor costs.[34] Although the EMU and unemployment are not directly related to each other, one possible scenario is that the single currency will act as a catalyst for structural reforms by increasing the pressure for change. Partial deregulation of labor markets in Italy and Spain, and Europe-wide trend to privatize state-owned industries (the public sector, as a percentage of GDP, is still much bigger in Europe than in America) augur well for Europe.[35] Generally speaking, the "Ins'" structural reforms are being implemented at too slow a pace. Ironically, two voluntary "Outs," that is Britain and Denmark, thanks to the deregulated economies in each of the countries, have the best capacity to deal with the EMU.[36]

Knowing that Europe does not fit the "optimal currency area" description, efforts were made to ensure that countries entering the EMU in the first wave would be alike in a few critical points, thus preserving the strength of new-born currency in its early days. But do these prerequisites really guarantee euro's shock-resistance?

CONVERGENCE CRITERIA: "INS" COUNTRIES VS. "OUTS" COUNTRIES

The 1991 Maastricht Treaty, the Treaty on European Union, mapped out conditions and a timetable for the transition to monetary union. Each potential member state had to fulfill five criteria, on a sustainable basis, prior to admittance to the EMU:[37]

1. A consumer price inflation rate no more than 1.5 percentage points above the average for the three countries (at most) with the lowest inflation rates;

2. Average nominal long-term interest rates no more than 2 percentage points above those for the three countries (at most) with the lowest inflation rates;

3. Participation in the European Monetary System [the system in which member states were required to maintain national currency exchange rates within certain fluctuation criteria] under normal bands and no exchange rate realignments for at least two years;

4. A sustainable government financial position, defined as a general government deficit to GDP ratio no more than 3 percent and a gross debt to GDP ratio no more than 60 percent (with exceptions if an "excessive" deficit is temporary, or an "excessive" deficit or debt ratio is declining at a "satisfactory" pace);

5. Additionally convergence should be measured by the balance-of-payments situation, the integration of markets, unit-labor cost, and other price indicators (real convergence).

A country whose economy is weaker than others might weaken the whole coalition. The purpose of these criteria was to filter out candidates in order to prevent the union from being destabilized by the premature admission of a country whose economic foundation was not yet compatible with those required by a fixed rate exchange. A central requirement was that trend inflation rates were the same. The first three criteria were intended to ensure this. Criterion one covered the recent past while rules two and three were intended to be more forward looking in nature.

Long-term interest rates were positively correlated with inflationary expectations. A recent devaluation was expected to increase inflationary pressure in the near future. Whether these criteria were sufficient is debatable, since convergence in long-term interest rates may simply reflect the credibility of the intention to move to monetary union. Furthermore, even if inflation had converged, the real exchange rate could still be some way from sustainable levels. These criteria were also debatable because with the introduction of a new currency, they were no longer regulated.

Criterion four, regarding fiscal variables, is not considered a strict convergence criterion and is different from previous criteria to the extent that it matters also after monetary unification. The intent of the transition

phase is to ensure that no country joins the monetary union when its public finances are in such a state that they might destabilize the monetary union. This criterion was included largely at the insistence of the Germans who feared that the euro would not be as strong as their currency.[38] Initially, to ensure the euro remained strong, the EMU was restricted to the six core members: Germany, France, Denmark, and the Benelux three (Netherlands, Belgium, and Luxembourg).[39] Nevertheless, the plan backfired and even the six core countries were experiencing problems meeting it. They have made recourse to exploiting the large room left for interpretation in the language of the E.U. criteria: the terms "excessive" and "satisfactory" are flawed by lack of a quantitative definition. Because of this ongoing practice of numbers fudging, they could no longer exclude the Mediterranean countries from entering. To qualify under the fiscal criterion, more and more countries adopted the art of "creative" bookkeeping. France counted a one-time transfer of cash from France Télécom to the government (0.5 percent of GDP) in exchange for the state's covering the company's pension liabilities.[40] Italy collected a "euro-tax" (0.6 percent of GDP) that will be partially refunded in future years.[41] Austria privatized public debt by shifting it to quasi-fiscal budgets (about 4.5 percent of GDP). Finally, Germany redefined its hospital debt, and unsuccessfully attempted to revalue its gold reserves in the face of furious opposition from the Bundesbank.[42]

Eleven out of fifteen E.U. countries were EMU's first-entrants: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal, and Spain. Yet entering the EMU was one thing, and being in the EMU is the other—all these countries must comply with constraints imposed on them by the Stability and Growth Pact, and this is not a one-time effort as convergence criteria were.

The last and most important addition to the EMU was the Stability and Growth Pact. It provides for agreed targets for national budgets, national deficits and national borrowing. It also provides for the imposition of substantial financial penalties against states that do not manage their budgets in line with the agreed targets. The initiative was Germany's and the proposed name of it was the Stability Pact. At the insistence of France president, Jacques Chirac, the Pact was renamed: "Growth" was added. During the Dublin Summit on December 13-14, 1996 the Council of Economic and Finance Ministers agreed to the Pact, but the new Socialist government in France refused to endorse it.[43] The Pact was finally ratified at the Amsterdam Summit on June 16-17, 1997.[44]

STABILITY (AND GROWTH) PACT

Germany managed to convince the other E.U. members to agree on somewhat demanding convergence criteria, to design the ECB according to the Bundesbank blueprint, and to locate the monetary authority in Frankfort on the Main.[45] Besides that, the German Council of Economic Experts (*Sachverständigenrat*) recommended to the German government that it persuade its European counterparts that a stable European currency requires an agreement on fiscal stability.[46] The logic behind this was as follows: the fiscal criteria for entry into the EMU are not sufficient because by definition they do not apply after entry, so at that time there would be no incentive for tightening government finances. This creates a hazard for the stability of the common currency: market participants may anticipate monetary policy to become more expansive in order to lower the real debt burden of highly indebted countries, to bail them out, or to inject additionally issued monies in case of insolvency.[47] Although these have been explicitly excluded in the Maastricht Treaty, the credibility of excluding a bailout is rated to be rather low.[48] The intention of a Stability Pact is, therefore, to penalize excessive deficits in order to discourage governments from becoming expansionist.[49]

> ***"The Stability and Growth Pact has plenty of loopholes and leeway. In effect, it provides a framework for governments to bargain over fiscal policy rather than a mechanism for committing them to a true deficit ceiling, as automatic fines assessed for violations would do."***

The original proposal provided for sanctions to be applied automatically with a let-out only if the economy had shrunk by over 2 percent in a year.[50] Governments failing to keep their budget deficit below 3 percent of GDP would have to place a deposit ("fine in waiting") with the European authorities and if excess borrowing continued, the deposit would be forfeited.[51] The "fine in waiting" is a non-interest bearing deposit that can only become a fine if, at the end of a two year period, the government concerned has not taken the steps necessary to rectify the deficit. Then it is up to the European Council's discretion to decide upon imposing the fine. Fines would be calcu-

lated at the rate of 0.2 percent of GDP plus another 0.1 percent for every percentage point by which the deficit exceeded the allowed ceiling. A deficit of 6 percent of GDP, for example, would have triggered the maximum fine of 0.5 percent of GDP.[52]

French ministers argued that any system of penalties had to be flexible and applied on a case-by-case basis and that sanctions for excessive deficits must remain a political matter.[53] A compromise was reached which defines automatic exceptions rather than fines. In case of an economic decline of less than 0.75 percent of economic growth, the countries agreed that "as a rule" they will keep their fiscal deficit below 3 percent of GDP, so the rules for an "excessive" deficit (Art. 104c of the Maastricht Treaty) apply as before.[54] In case of an economic decline between 0.75 percent and 2 percent, countries can plead "exceptional circumstances" in order to avoid a fine which may be as big as 0.5 percent of GDP.[55] In practice, this means that a six-step procedure involving the EC and Council of Economic and Finance Ministers is set in motion, what provides a considerable scope for political discretion. In case of a "severe economic downturn" (an economic decline of more than 2 percent of GDP), the EMU members will be free to allow themselves fiscal deficits above the set threshold and provisions of Article 104c do not apply at all.[56] Additionally, no penalty deposit applies if the excessive deficit can be considered an "exceptional deficit;" and this may arise in two ways. First, a deficit will be considered exceptional where it results from an "unusual event outside the control of the Member State that has a large impact on the financial position of the government."[57] The definition of what constitutes an "unusual event" or a "large impact" is noticeably and significantly absent.[58] The German Finance Minister, Theo Waigel, ultimately described the final package as being a "quasi-automatic" system of penalties while the French European Commissioner for economic, monetary and financial affairs, Yves-Thibault de Silguy, described it as being "as automatic as the treaty would allow."[59]

The Pact was designed in a way that should create an environment for the ECB to conduct a stable monetary policy. However, this position is under debate. There is little evidence that budget deficits or high debts, per se, undermine currencies.[60] Just the opposite is revealed by the strong dollar in the 1980s and strong D-mark in the 1990s, both achieved at times of huge budget deficits.[61] Regarding big debts, Belgium for years had the largest debt as a proportion of GDP in the Organization for Economic Cooperation and Development, yet it has been able to maintain a strong currency in union with Luxembourg, the country with the smallest debt.[62]

The concerns about potential moral hazard—to borrow and spend at everyone else's expense, increasing interest rates for all—are likely to be overstated. First, the "Ins" countries are borrowing in euros, not in national currencies they can directly control. Because the European Central Bank is explicitly barred from bailing out national governments, it should be expected that markets would pay more attention to national borrowing and start imposing an interest-rate premium in case it gets too high.[63] Second, an individual country's borrowing, however large, in comparison with the size of global capital markets is too small to have a sizable effect on euro interest rates. Mexico's huge dollar borrowing in 1995-96 did not raise U.S. interest rates.[64] Third, if the European Central Bank stays as independent as it is suppose to be, it won't be feasible for a country that has accumulated euro-denominated debt to put pressure on the European Central Bank to increase inflation. Fourth, a deliberate default threat hardly seems credible in the E.U. context. Finally, the remedy is to remove the threat of systemic risk through appropriate financial-sector regulations to ensure that no key financial institution is excessively exposed to the sovereign debt of any member country.[65] Perhaps the worst outcome of the Pact is the fact that it undermines the treaty's no-bail-out rule by suggesting there is a fiscal problem that needs solution at a European level, instead of insisting that each country's fiscal stance is a matter for it and it alone.[66]

CONCLUSIONS AND RECOMMENDATIONS

°What adjustment mechanism is left to an "In" country experiencing asymmetric shock? In a single currency zone the adjustment mechanism traditionally provided by national currencies, i.e., to inflate independently, set short-term interest rates, and borrow heavily, are removed, due to abolishment of national currencies and Stability Pact requirements. A single European short-term interest rate, set by European Central Bank, applies indiscriminately to all "Ins." In fact, the short-term interest rate alone acts as a shock, because growth rates, and hence inflationary pressures, differ across Europe. For example, Ireland's economy grew by 10 percent in 1997, while Germany's grew by 2.5 percent.[68] This suggests that Ireland needs higher interest rates than Germany in order to attract more capital. Even if all countries were at the same point in the economic cycle, differences in the way interest rates affect output across Europe mean that a given rise in rates would depress some economies more than others.

Higher interest rates influence economies in three

main ways. First, they raise the cost of borrowing and therefore deter new investment or purchases of consumer goods on credit.[69] Second, there is an "income effect:" debtors feel poorer because their debt-service has gone up.[70] Third, there is an exchange rate effect: the domestic currency is pushed up against other currencies and so reduces exports.[71] Four consequences follow. First, the higher the proportion of borrowing that is at short term or variable rates, the bigger the income effect and hence the drop in consumer spending. Lending on such terms is most popular in Austria and Italy, while in France, Germany, and the Netherlands borrowing is mostly long-term and at fixed rates.[72] Second, banks vary in the speed with which they pass on rises in official interest rates to their customers.[73] Third, countries with lower level of private-sector debt, like Italy, Germany and Belgium, will be hit less hard than heavily indebted ones.[74] Fourth, the more open an economy, the bigger will be the impact on output of an appreciation of the euro against the dollar. Ireland and Belgium are the most exposed: their exports outside the EMU area account for 34 percent and 21 percent of GDP respectively, compared with around 10 percent or less in France, Germany, Italy, and Spain.[75] In the case of any particular country, these effects offset each other to some extent. Another remaining issue is the distribution of *seigniorage* wealth. In some instances, it might ease the negative impacts of other factors, but in the other, it may also overlap with them.[76] The creation of the EMU could help, over time, to reduce differences between countries and hence improve convergence in the impact of monetary policy. But this won't happen overnight. Meanwhile, readily available solutions must be employed to deal with contingencies.

The loss of national currencies by itself should not be a problem. In an increasingly integrated and interdependent Europe, the independent use by a member country of monetary policy or exchange rate adjustments relative to other E.U. currencies is seldom easy to justify. Devaluation causes tensions inside a single market. French officials claim that in 1993 France lost nearly 1 percent of GDP due to "competitive" devaluations in Italy and Britain.[77] As for devaluation, most studies suggest that its beneficial effects, e.g., on reducing unemployment and stimulating export, are at best temporary.[78] Over time they are overwritten by more expensive imports and borrowing resulting from less credence in a currency due to its decreasing purchasing power and a fear of inflation getting out of control.[79] The pro of inflation is that it allows the downward adjustment of real wages: it is not reasonable at this time to expect that people would accept reductions in their nominal wages, but if increase in nominal wages is smaller than inflation, then effectively real wages decrease.

With currencies and interest rates locked together, fiscal policy under the EMU will have to carry more of the burden of cushioning recessions than it did until recently. The Stability and Growth Pact has plenty of loopholes and leeway. In effect, it provides a framework for governments to bargain over fiscal policy rather than a mechanism for committing them to a true deficit ceiling, as automatic fines assessed for violations would do. The danger behind the lax procedure is a reduced incentive to pursue structural reforms. On the other hand, it might appear that this approach is preferable. Under Germany's strict proposition, governments would need to run budget surpluses during "normal" times, leaving room for borrowing to rise during recessions.[80] In this way the automatic stabilizers of fiscal policy would be allowed some scope to work. Otherwise, a country that begins to move into recession, to prevent its deficit from rising above the ceiling, would have to cut spending and increase taxes—thereby aggravating the slow-down and placing further upward pressure on borrowing. Thus, the country actually increases the chance of failing to hold its deficit below the ceiling. The "fine in waiting" mechanism will further deepen the recession. At this moment, it is impossible to predict which scenario will play out as too many uncertainties are involved. Certainly the key strategic calculation for EMU-participating governments is to determine how much budgetary flexibility they need to keep in store for emergencies.

In any case, the pace of structural reforms should be substantially accelerated so the underlying factors of economic inefficiencies would be permanently removed. The EMU creates a qualitatively new environment. Assuming that necessity is a basis for adaptation to certain circumstances, Europeans' unwillingness to live and work abroad as well as "natural" resistance to earn less in nominal terms might be expected to evolve towards acceptance. If this happens, the most powerful adjustment mechanisms will come into play. Governments should encourage labor mobility by, for example, expanding exchange programs at the state universities. It is likely that after graduation a considerable percentage of international students will find a job and settle down in a country in which they studied. If afterwards this country encounters recession resulting in increase in unemployment rates, they will be the first to respond to such a shock by migrating back to their countries of origin. Even for those that will go back to their home countries immediately upon graduation from a foreign university, it will be much easier to search for a job anywhere abroad if this is profitable. It is strongly recommend that these types of behavior be

promoted through a variety of economic incentives like tax-breaks for universities and study-abroad scholarship programs. The ultimate goal of this approach would be to erase language, cultural, and psychological barriers inhibiting labor mobility.

The EMU is not an inherently good or bad idea. Its execution will eventually determine the degree to which EMU will prove a success or a failure. Much depends on the initial credibility of both the new currency and the new bank. In the light of the highly politicized election for the first (and second) president of the European Central Bank, one can lose faith in whether the European Central Bank's independence, and thus the euro's strength, is certain. The recommendation, therefore, is to establish and enforce procedures that will prevent bank's administration from becoming sensitive to political pressures thus guarding its statutory independence. The key issue such preventive measures should focus upon is a separation of national governments from a protocol adopted for appointing the European Central Bank's high officials that constitute decision making bodies. This concerns the European Central Bank Executive Board (President, Vice-President, and other four members) as well as the governors of the national central banks. The Executive Board and governors form a Governing Council.[81] Another threat of political sway that the Governing Council should be prepared to face in the foreseeable future is the Euro Council, or Euro-X.[82] Euro-X, an informal body comprising of finance ministers supported by French advocates, is supposed to be a political counterpart to the European Central Bank.[83]

Cancellation of EMU is officially out of the question, and even if its termination were possible, it would have disastrous effects. Even worse would be the collapse of the EMU under speculative attack. To minimize exposure to that risk, the European Central Bank's course of actions must be clear and consistent for markets to have confidence in both the EMU in general and the European Central Bank and euro in particular.

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Notes

1. E.U. Member States as of March 1999: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, Sweden, The Netherlands, and the United Kingdom.
2. The "Six" refers to countries that signed the Treaty of Paris on April 18, 1951 establishing the European Coal and Steel Community (ECSC).
3. European Commission, *Chronology of the European Union: The Economic and Monetary Union,* http://www.europa.eu.int/abc/obj/chrono/en/them7.htm. Accessed: February 13, 1999 (European government information Web site).
4. European Council, *1-3 May 1998—Special "EMU" Council: 2088th Council meeting, Brussels, 2/3 May 1998.* Online. Available: http://europa.eu.int/euro/html/dossiers/00140/00140-en.pdf. Accessed: February 18, 1999.
5. European Commission, *Euro Guide,* http://europa.eu.int/euro/html/dossiers/00225/00225-en.pdf. Accessed: February 13, 1999 (European government information Web site).
6. Greece is expected to join in 2001.
7. European Council, *1-3 May 1998—Special "EMU" Council: Council decision of 2 May 1998 in accordance with Article 109j(4) of the Treaty.* Online. Available: http://europa.eu.int/euro/html/dossiers/00137/00137-en.pdf. Accessed: February 18, 1999.
8. The Council of the European Union (European Council), *1-3 May 1998—Special "EMU" Council: Meeting of the Ministers for Economic Affairs and Finance, Governors of Central Banks, European Commission and European Monetary Institute, Brussels, 3 May 1998.* Online. Available: http://europa.eu.int/euro/html/dossiers/00141/00141-en.pdf. Accessed: February 18, 1999.
9. European Commission, *EMU Timetable: What Will Happen and When,* http://europa.eu.int/euro/html/calendrier5.html?lang=5. Accessed: February 13, 1999 (European government information Web site).
10. Michael Brandl, "MBA Macroeconomics," (draft, computer printout).
11. *The Economist,* "Business this week February 20th—February 26th 1999," *Business This Week,* February 25, 1999, business@lists.economist.com. (Newsletter.)
12. Ibid.
13. Note, that this implies that such a bank is politically controlled, hence, it cannot be a case in event of banks run independently from governments.
14. Edwin Mansfield, *Principles of Macroeconomics,* 4th ed. (University of Pennsylvania Press: New York, 1983), p. 375.
15. Ibid., p. 377.
16. "A Survey of EMU: An Awfully Big Adventure," *The Economist,* vol. 347, no. 8063 (April 11, 1998), p. 17.
17. Ibid., p. 5.
18. Ibid.
19. Ibid., p. 6.
20. Ibid.
21. Ibid.
22. Emerson, *One Market, One Money,* (Frankfurt am Main: European Commission, August 1990), p. 47.
23. "Survey EMU," p. 6.
24. Ibid.

25. Antonio Fatas, “Redistribution vs. Insurance: Does Europe Need a Fiscal Federation?,” *Economic Policy,* vol. 183 (July 1998), p. 56.
26. “Survey EMU,” p. 6.
27. Ibid.
28. Heathcoat, *A Single European Currency.*
29. Sir Donald MacDougall, “Economic and Monetary Union and the European Budget,” *National Institute Economic Review,* vol. 3 (May 1992), p. 97.
30. “Survey EMU,” p. 21.
31. Ibid., pp. 9, 20.
32. Ibid., p. 7.
33. Ibid.
34. Ibid.
35. Ibid., p. 8.
36. Ibid., p. 22.
37. European Commission, *Protocol (No 6) on the convergence criteria referred to in Article 109j of the Treaty establishing the European Community.* Online. Available: http://www.europa.eu.int/abc/obj/treaties/en/entr8g.htm#28. Accessed: March 5, 1999.
38. “Survey EMU,” p. 8.
39. Ibid.
40. Ibid., p. 9.
41. Ibid.
42. Ibid.
43. European Council, *Dublin European Council, 13 and 14 December 1996, Presidency Conclusions: Economic and Monetary Union.* Online. Available: http://europa.eu.int/euro/html/page-dossier5.html?dossier=57&lang=5&page=4&nav=5. Accessed: February 18, 1999.
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46. Ibid.
47. Ibid., p. 13.
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"Toward a New Measure of Poverty for the Twenty-First Century." John Robert Righter. First Reader: John C. Dougherty IV.

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