

Martin Baily

Editor's Note: *This is an abbreviated version of RF's conversation with Martin Baily. For the full interview, go to our Web site: www.richmondfed.org/publications*

Martin Baily's career has spanned a number of fields, from academia to government to business consulting. His research interests have been equally varied, resulting in important contributions to a variety of topics in macroeconomics.

A native of England, Baily has written recently about how Europe could reform its economy in a way that would yield faster economic growth while retaining many aspects of its generous social safety net. He has also investigated the link between information technology investment and productivity improvements, and the causes of increasing income inequality in the United States and abroad.

Baily has taught at the Massachusetts Institute of Technology, Yale University, and the University of Maryland; been a senior fellow at the Brookings Institution; and was a principal at McKinsey & Company's Global Institute. During the Clinton administration, he served as a member and then chairman of the Council of Economic Advisers (CEA). Since leaving the CEA in 2001, Baily has been a senior fellow at the Institute of International Economics in Washington, D.C., where Aaron Steelman interviewed him on Aug. 8, 2006.



RF: What are the principal reasons for the rise in wage inequality in the United States over the past 30 years? How important does skill-biased technical change figure into this story?

Baily: Most economists would argue that skill-biased technical change is the most important factor, and I agree with that. The liberalization of trade has had some effect as well. The trouble with attributing wage trends to technical change is that this is a residual explanation. The inference comes from looking at shifts in supply and demand curves, but to interpret those shifts, you need to look deeper.

One of the things that has happened is that wages used to be determined institutionally but that is much less true today. Unions were much more important than they are now. Corporations had fairly standard compensation schedules for their mid-level employees. And even at the upper levels, the salaries of a CEO or CFO were largely determined by historical patterns. Over the last 20 years, we have had a much more competitive economy, in all regards. This has led companies to change the way they determine compensation for their employees. Instead of setting wages by institutional means, companies are really fighting for talented people, and this has driven up their salaries quite dramatically. At the same time, the share of the population that is in manufacturing has declined, and even those who still work in that sector tend to command relatively lower wages. In today's economy, much of the returns from economic growth goes to people with special skills or higher levels of education.

RF: Recent data seem to show that the growth in wages at the very top of the distribution — say, the top 1 percent and above — is very sharp. Can the skill-biased technical change story explain that phenomenon or is there something else that has led to the spike at the very top?

Baily: It depends on how you define skill-biased technical change. The growth you have described certainly cannot be explained by returns to education, though that certainly plays a big role when you look at income growth across the population as a whole. Certain skills are valued very highly in today's economy, and the people who possess those skills are doing very well. I sit on the board of a small company and it is very difficult yet very important to find a really strong CEO and others in top management positions. We are in an extremely competitive environment, much more so than 20 years ago, and it has become essential to find the best people available.

RF: How does the pattern of wage inequality in Europe compare to that in the United States? Have some of continental Europe's social and labor policies had the effect of keeping the gap from widening as much as in the United States?

Baily: The wage distribution in Europe is much more compressed than it is in the United States. The one exception is the United Kingdom (UK), which looks more like the United States than the rest of Europe. The question is why? In continental Europe, wages are largely still set according to long-standing institutional agreements. Unions are much more important, and even in countries where the share of the work force that is unionized is fairly low, like France, it's still the case that union-determined wage scales are widely used. Also, in many countries you have either a relatively high minimum wage or you have social welfare programs, which means that people are not willing to work for the type of wages you see in other parts of the world, so that effectively creates a wage floor. And at the CEO level, you just don't have the type of open market that you do in the United States. All of this leads to a much more compressed distribution of wages.

Some of this is changing. There is a real concern that the European economy is not sufficiently dynamic. But the type of inequality that you see in the United States is viewed very unfavorably, so it's not clear whether, politically and socially, Europe will be willing to make significant changes to its labor market policies.

RF: Why do you think views toward egalitarianism in Europe differ so much from those in the United States?

Baily: Well, that is certainly one of the classic questions in social science and I don't claim to be an expert on the issue. But the tradition of the United States as an immigrant country where the immigrants from Europe, especially,

came to get away from the more structured societies in which they were born — that, I think, still has an important legacy. I grew up in England but I have been here a very long time, and during that period I have seen significant changes in the UK. In fact, it is now lumped together with the United States as part of a broader Anglo-Saxon political and economic culture. You now have the high-priced CEOs and lawyers in London like you do in New York and other financial centers in the United States. This is a big change. England was traditionally one of the most rigidly class-based cultures in Europe, but economic mobility has increased a lot, as companies have gone after the most skilled employees they can find regardless of their social backgrounds. So I don't think social mores are set in stone — they do evolve over time — but there are still significant differences between the United States and Europe.

There is an emerging literature among economists that looks at long-standing social institutions and beliefs and how they have affected economic development. It's a very interesting body of work. I don't agree with all of it, of course. I think some papers have been too ambitious in trying to explain a country's evolution based on a few specific traits or events. But there is no doubt that social and cultural factors affect institutions, which then affect economic performance.

RF: In *Transforming the European Economy* and other publications, you have argued that many countries need to enact a series of reforms if they wish to grow more quickly. Could you please talk about the type of reforms you have in mind? Which ones are most important? And which ones might be the most difficult to implement?

Baily: I have been involved with the McKinsey Global Institute, working on a number of studies in which we try to understand why there are differences in productivity across countries. The one thing that comes across most clearly is that competitive intensity — particularly being forced to compete against world best practices — drives industries to achieve higher rates of productivity. I don't want to present our results as saying we should get rid of all regulation because we don't say that. But it has often been the case that regulation gets co-opted by an industry in order to restrict competition, so you need to be careful about how regulations are implemented and whether they are achieving their desired end.

It's important to understand what we mean by competition. Simply having a lot of companies in a market does not mean that the market is particularly competitive. Instead, what you might have are fragmented industries that have not consolidated and not invested in the most modern technology or implemented other desirable changes. So you might have a lot of banks or retail stores, for instance, but they are not operating at best practice because you have not allowed the industry to evolve.

Where regulation has been changed in a way that encourages competition, though, you have seen a lot of success.

For instance, if you look at the mobile phone industry in Germany and France — a relatively new industry that didn't have a long legacy of regulation — it has achieved very high rates of productivity, at times even higher than in the United States. We also did a recent study of Sweden that looked at which industries had been deregulated since Sweden joined the European Union in 1995 and were forced to face up to Europe-wide competition. We found that productivity growth generally has been very good. The one domestic industry that has not seen much improvement is construction, which is still subject to a great deal of regulation with very strong union rules.

So overall, the news is good. If you do the right things — not necessarily by abolishing regulation but by changing it in a way that is competition-enhancing — then you will see productivity growth in Europe.

In addition to reforming business regulation, there is the question of Europe's social welfare policies. Here we see that opposition to change is pretty strong. Europeans would rather sacrifice some level of economic efficiency for greater protection against poverty and hardship. That's their choice. But you could provide those social protections in a way that is much more market-friendly. For instance, if you were to have wage insurance rather than permitting people to draw unemployment insurance for a long time, then you could encourage people to go and get another job rather than stay out of the labor market altogether. I'm sympathetic to someone who is 55 years old and is suddenly laid off from a well-paying job in the automobile industry, for instance. But you just can't function by having everyone on social welfare. It pushes up the tax burden too high and it blunts the incentive to work.

My co-author of *Transforming the European Economy* is Danish. The Danes have not implemented a perfect system but it does a reasonably good job of providing social support while also providing incentives for people to find a job and go to work. They don't have the option of simply saying, "no thanks." That's a big difference between Denmark and Germany. Germany ostensibly has rules that are designed to get people back into the work force, but if you go to Germany and ask them how many people have been forced off the unemployment benefit rolls, the answer is not very many. So, in practice, it doesn't work very well.

You also need more flexibility in Europe's labor market. We think that companies should be allowed to more easily implement layoff programs, with severance packages. The French system is horrendous, where the legal system gets involved almost every time a company wants to restructure.

RF: It seems that the transition to more liberal labor policies in the United Kingdom has, on balance, benefited the UK economy. But they were won under quite difficult circumstances. Do such reforms — in liberal democracies, at least — require almost a crisis to occur, such as the malaise that the UK economy found itself in during the late 1970s, in order to be implemented? Also, how important is it to have a persistent and charismatic figure, such as Margaret Thatcher, leading the government?

Baily: In England there were so many entrenched interest groups and so much conflict in the labor market that having someone who was willing to be tough was helpful. But other countries have been able to enact reforms without a figure comparable to Mrs. Thatcher. Significant labor market reforms were enacted in the Netherlands, Sweden, and Denmark. Now it's true that those countries' economies were approaching crisis levels, with high unemployment and a lot of people on social support programs, which caused budget problems. Indeed, growing fiscal imbalances have probably been one of the main drivers of reforms in Europe. So I think it's often a mixture of having strong political leaders combined with declining economic performance that leads to reform.

My colleague Adam Posen is writing a book on Germany and he disagrees, arguing that it's actually easier to enact reform if the economy is doing well. When people have jobs and the economy is expanding, people are more will-

ing to tolerate changes that they might have otherwise found more painful. I understand that argument, but my own view is that the experiences from the UK and the Netherlands are strong counterexamples. The reforms those countries achieved were easier to make because their economies were in crisis and it was clear that something had to be done.

Martin Baily

► Present Position

Senior Fellow, Institute for International Economics

► Previous Faculty Appointments

Massachusetts Institute of Technology (1972-1973), Yale University (1973-1979), and the University of Maryland (1989-1996)

► Government Experience

Member, Council of Economic Advisers (1994-1996); Chairman, Council of Economic Advisers (1999-2001)

► Other Positions

Senior Fellow, Brookings Institution (1979-1989); Principal, McKinsey & Company's Global Institute (1996-1999)

► Education

Ph.D., Massachusetts Institute of Technology (1972)

► Selected Publications

Author or co-author of several papers in such journals as the *American Economic Review*, *Quarterly Journal of Economics*, *Journal of Political Economy*, and *Journal of Economics Perspectives*; co-author of *Growth with Equity: Economic Policymaking for the Next Century* (Brookings Institution, 1993) and *Transforming the European Economy* (Institute for International Economics, 2004)

RF: What significance does the relatively low birth rate in some European countries have for social policy, especially programs aimed at helping the aged?

Baily: First, I would like to point out that the birth rate among females of European origin in the United States is relatively low as well, so there is a common pattern between the two regions. The overall U.S. birth rate figures are much higher than in Europe because many recent immigrant groups are boosting the rate. And, of course, immigration is itself boosting the U.S. population. What are the implications for Europe? The low birth rate means that a growing share of the population will be of retirement age and labor forces will be flat or declining. This could produce an unstable equilibrium. As the percentage of people receiving government retirement funds increases, that means increasing taxes on those who are still working, which could lead some people to leave the labor market. That's not a forecast — it's more of a warning parable.

So Europe has to look closely at this issue and the sooner you do something about it — by changing the incentives for people who are already working to stay in the labor force longer and those who are out of the labor force now to acquire jobs — the better off you will be. The shifting worker-retiree ratio is not tenable. It's going to be too costly to fund the public pension programs as well as the health care programs. The same is true, to some extent, in the United States, especially with health care.

RF: How important has investment in information technology (IT) products been to the surge in productivity that we have seen since the mid-1990s? And if IT was significant, why didn't we see productivity gains earlier? Companies were investing in IT throughout the post-1973 period, yet we saw relatively low rates of productivity growth for more than 20 years.

Baily: If you think that IT investment has been important to the growth in productivity, and I believe it has been, then the simple answer to your question is that the level of investment in IT was pretty small relative to the size of the overall economy during the early part of this period. Also, it took quite awhile for a lot of computer software to become user-friendly enough so that a broad range of employees could use it effectively. Plus, in the 1990s you had parallel development in communications technology, which made a lot of IT products more useful.

Looking at things more recently, we have seen a real slump in IT investment. Yet productivity continued to grow fairly rapidly. So the link between IT investment and the



rapid overall productivity growth that we witnessed earlier has subsequently broken down. What we have learned is that productivity depends on companies improving their business processes, and while IT can be an important facilitator of doing things more efficiently, it isn't always the case. A lot of investments in IT didn't pay off in the way that companies had hoped. For example, a lot of banks and hotels and other firms invested in Customer Relations Management (CRM) software. Many of them reported that it didn't result in a very large payoff.

There was a general feeling that you had to invest in IT, and people didn't really pay a lot of attention to the budget and where they could get the most bang for the buck. This led to some overinvestment. But companies now are

beginning to learn which investments were most effective and how to make best use of the products they have. We are seeing another period of learning-by-doing, in the post-2000 period.

RF: What do you think accounts for the extreme enthusiasm many investors had in the late 1990s for anything related to IT? Would you define that period as a "bubble"? And what was it like to be in a key policy advisory position as both the tech boom and decline occurred?

Baily: The very rapid rise in technology stocks was a bubble, and the overall stock market was also in a bubble, but less pronounced. The prices many companies' stocks were fetching could not be justified by their profits.

Was the overall U.S. economy in a bubble? Things were pretty good in a lot of ways over that period. There was low unemployment, inflation was falling, and incomes were rising. The private sector, of course, was the biggest reason for this prosperity. But on the policy side, I would give the Clinton administration credit for embracing change and being willing to stand up to interest groups that wanted to restrict trade and pursue other counterproductive interventions. You can certainly criticize particular measures, but on balance, it was a very good record. One of my colleagues said, "Bill Clinton baby-sat the U.S. economy into the 21st century." It was important that you had a president who was willing to embrace that type of transition.

Now, obviously, there were some concerns. The trade deficit was ballooning and the dollar was very high. I thought that if we balanced the federal budget, you could mitigate some of those problems, because even though private savings were down, public savings would go from negative to positive. We did balance the budget, but the effects on the trade deficit were not as significant as I thought they

would be. This was very hard on the manufacturing sector. I don't think it was the main reason for what happened to manufacturing employment, but it was certainly a contributing factor. If you look at the numbers, manufacturing employment remained relatively strong through 2000. The downturn in the domestic economy generally was the biggest factor in the decline in manufacturing employment.

Six years later, we still have a huge trade deficit that will have to adjust eventually. A trade deficit at the current level is not sustainable over the long run. The adjustment will be somewhat painful for the United States, because we have been spending more than we have been producing. Just as it's more fun to run up a balance on your credit card than to work it off, the adjustment of the U.S. economy to a lower deficit and a lower level of foreign borrowing will be difficult. It will be somewhat painful for the rest of the world too, because they have become used to selling to the U.S. market, and they will have to get used to generating more domestic demand.

That said, Robert Lawrence and I have been doing some work on this, and we are more optimistic than many others. If the dollar does come down, so will the trade deficit — not the energy part, but the manufacturing and services parts. Exports will rise and imports will decline, meaning that over a period of several years, we will be able to achieve something close to a trade balance. So while I share some of the concerns of people like Nouriel Roubini, Ken Rogoff, and Bob Rubin that we could experience a very painful adjustment, I don't think that is the most likely outcome. There are too many countries with too big a stake in keeping the U.S. economy from stumbling badly, so there would be enough intervention to forestall a crash in the dollar. But we could certainly see higher interest rates, which could affect the housing market and a falling dollar could have some inflationary effects.

RF: In addition to the policies you have already mentioned, what do you think were the principal economic successes of the Clinton administration?

Baily: Balancing the budget was a bipartisan effort, to be sure, but I give the administration a large amount of credit for that. And they were able to do it while still making significant progress in improving the resources available to people without a lot of skills and education. Welfare reform was also a very big achievement. NAFTA was an achievement as was getting China into the WTO. So there are many things that I think the administration did that were good for the long-run health of the economy.

RF: In your opinion, how ought the United States handle reform of the Social Security and Medicare systems?

Baily: The problem with Social Security is not that severe. You could get it on track with some increases in the retirement age and perhaps some modest increases in taxation. The current gap is not that great.

I would like to see people in the United States saving more. So I would like to see some sort of private accounts layered on top of Social Security. We have that in the form of 401(k) programs, but a lot of people don't participate. Many people simply don't realize the magnitude of resources they are going to need to retire. So I favor private accounts, not as a replacement to the existing system but as an addition.

The obstacle to that is: If it's compulsory, then it's viewed as taxation, and if it's not compulsory, then a lot of people will not participate. If you made the default option such that people were automatically included in the system, then participation rates would be pretty high and you wouldn't have the objection that you were imposing a new tax because people could opt out. The advantage of doing it through Social Security is that you would have the government collecting the money and then have it invested by professionals in the private sector. This would cut down on the cost of administering the program and it would also allow you to restrict the range of investment vehicles that people could choose. In general, I favor increasing consumer choice, but some people make bad choices with their retirement investments and there's a good case for eliminating some very high-risk options.

Turning to Medicare, I don't have a good answer. Ultimately, we have to institute some form of rationing of health care. I don't mean that in the way that many people perceive it. We ration all sorts of goods because we have to make choices about how we spend our money. When we get rid of that, by instituting a system of third-party payment, we are no longer operating in a real market system. So we have to decide what's going to be the effective "limit" — I think that it is probably a better and more accurate term than "ration."

Managed care is one approach to setting limits but it didn't really get the chance that it needed. I understand why people don't like it. They want short waiting times, they want to be able to choose the specialists they need, and so on. Managed care put limits on those choices — it limited health care that, at the margin, provided very little benefit for the cost. But patient opposition to the limits was mobilized through the courts and with regulations. Managed care providers relaxed the limits in response and health care costs started rising again.

The response today among employer-provided health insurance plans is to increase the amount of money that the individual patient has to pay, so that ability to pay becomes the limiting mechanism. I don't think that's the best solution because it reduces the level of insurance and means that some people will miss out on care that they need. But it is probably the mechanism that will be used to reduce the growth of Medicare spending also. A better way, if it could be achieved, is to determine through research the treatment protocols that are the most cost-effective and then align the economic incentives for patients and providers to encourage the use of these protocols.

RF: There was much anti-globalization talk in the United States in the late 1990s — the protests at the World Trade Organization (WTO) meetings in Seattle, for instance — but, overall, that sentiment has seemed to wane a bit. What do you think is the current state of public opinion toward globalization, and what effect might it have on public policy?

Baily: Globalization still is not very popular. It's not very popular in the United States, Europe, or the developing world. There's a legitimate reason for it — it brings change and can force people to acquire new skills and change jobs. That can be painful. People also exaggerate the effects of globalization. We talked earlier about skill-biased technical change. Even in a world without globalization, there would still be a lot of change in many industries. It is easier to blame globalization than technology or productivity growth. Also, the United States is such a large market that the level of competition you see in other parts of the world through globalization still occurs here from domestic companies alone.

I am a fan of globalization, which is good for the economy. Gary Hufbauer, my colleague here at the Institute, estimates that it contributes a trillion dollars a year to U.S. income. But it's important that we do a better job of helping the people here who do not have a lot of education and skills, either by having a better social safety net or by improving access to education and job training. I would like to see our economy made safer, in some sense, for globalization. And that would reduce anxiety and opposition toward it.

RF: What do you make of the current debate on immigration reform? How should the United States — and other rich countries — address this issue?

Baily: I favor immigration. As I have stated, I am an immigrant myself. But there is a concern that the current level of low-skilled immigration is putting downward pressure on the wages of low-skilled workers born in the United States. It would be desirable to reduce the pace of immigration in a way that limits the damage done to people at the bottom end of the income distribution. How you do that, though, can be very tricky and I can imagine reforms that would be counterproductive.

RF: Do you favor an increase in the minimum wage? Would expanding the Earned Income Tax Credit (EITC) be a more desirable way to help low-income Americans?

Baily: Looking at this from the standpoint of incentives, it's better to increase the EITC than the minimum wage because the EITC encourages employment. The concern about the minimum wage is that it can price some people out of the labor market. However, given its current level,

I would support a modest increase in the minimum wage. It's a blunt instrument but it helps a certain segment of the work force, as long as it is not raised too high.

RF: Many cities have tried to pitch themselves as high-tech centers to potential employers and citizens. Are policymakers in those cities overreaching? That is, can public policy be used to steer a local economy in that direction or must those changes occur more organically?

Baily: Generally, the importance of high tech has been exaggerated. It is important but many people look at it as much more of a savior than it can possibly be. There just aren't that many jobs in the high-tech sector, especially in the manufacturing of high-tech products.

On the broader issue of economic geography, there are a lot of examples of cities that have suffered large declines and were able to come back. So it's certainly not impossible. But in some cases, it's going to be very difficult to do that, and policies aimed toward that end often will be a waste of money. It's similar to the way we look at certain industries. Some are going to rise and decline over time and you ought not try to stop that process. The same is true with cities. It's a mistake to try to preserve every place in the form that it existed decades ago. To the extent that government can play a role here, it's in doing a good job of providing basic services, from public safety to education. Those things are going to be important to any city's well-being and ultimately will help economic development.

RF: How would you assess the role of the Council of Economic Advisers (CEA)? What influence does it have and which things can it do most effectively?

Baily: The role of the CEA has changed a lot over time. In the early 1960s, for instance, it had a lot of influence. There were some very big questions that the executive branch was grappling with — how to sustain economic growth and price stability while fighting an increasingly expensive war in Vietnam. Over time, that influence has waxed and waned. A lot of it has to do with the president. I served on the CEA under President Clinton and he was very intellectually curious. He was genuinely interested in policy debate, and I always felt that he closely considered the advice that we offered, whether or not he ultimately accepted it.

As for what the CEA can do best, a lot of that involves things that cannot be seen publicly. For instance, the CEA is often asked to assess proposals coming from Congress or other parts of the administration. Many of those proposals would have very bad consequences, and it's important for the CEA to frame those issues in a way that can help foster useful discussion among policymakers. So while the CEA can have a public face, much of its work takes place out of the public view.

RF