

WINTER 2005

REGION FOCUS

THE FEDERAL RESERVE BANK OF RICHMOND

BANKS BRANCHING OUT ...

**It's All About
Location,
Location,
Location**

**Shame and Bankruptcy
ACC Shuffle • Inflation Targeting Debate**

REGION FOCUS

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COVER:
Skyline of Charlotte, N.C., one of America's banking hubs
PHOTOGRAPHY: ANNE RIPPY/GETTYIMAGES

Does Deregulation Undermine Stability?



One of the Federal Reserve's most important duties is to make sure that the nation's financial system is stable. But how should we and other bank regulators go about achieving this goal? That's a large and complicated question.

In many ways, the banking industry in the United States was shaped by the events of the 1930s. The collapse of a number of

financial institutions led to regulations that limited the activities of banks. This was meant to shelter them from risk and to prevent additional collapses. At the same time, efforts were made to protect the consumer from another wave of bank failures. In particular, the federal government began insuring deposits through the Federal Deposit Insurance Corporation.

A quick glance at the post-Depression history of the banking industry would seem to vindicate these decisions. Until recently, many of the regulations that went on the books in the 1930s were still in operation — and overall, the industry has been quite stable, with relatively few failures. But does this necessarily mean that such regulations were the best — or only — course of action? I don't think so.

In fact, research suggests that the collapse of the 1930s could have been averted — or at least would have been considerably less severe — had the regulation of the banking industry been less restrictive prior to the Depression. As the cover story in this issue of *Region Focus* discusses, branch banking has grown dramatically in the United States in the past decade. Freed from regulations that confined their business activities to specific states or geographic regions, some banks are now operating on a nearly national scale, with branches throughout the country.

At first blush, such expansion might seem like a potentially risky phenomenon. After all, the bigger an institution gets, the more it has to lose, right? At one level this is correct: The collapse of a large bank with branches in numerous areas would pose a significant problem to the nation's financial system.

But the data pose an interesting problem for proponents of regulation. Prior to the Depression, some states prohibited branch banking while others allowed it. In addition, some states already had deposit insurance programs of their own. How did the different states fare? On balance, banks in states that permitted branch banking and did not adopt deposit insurance programs performed better than banks in states with tighter regulatory environments.

Deposit insurance programs presented a moral hazard problem: Some banks got too big too fast, secure in the knowledge that there was a safety net to protect them from bad business decisions. The problem was particularly acute in heavily agricultural states, where banks loaned freely during the agricultural boom of 1914 to 1920, but faced hard times when farm goods prices began to fall. In fact, all the state deposit insurance fund systems collapsed during the 1920s.

Meanwhile, branch banking proved quite successful. As Columbia University economist Charles Calomiris has written, "States that allowed branch banking saw much lower failure rates — reflecting the unusually high survivability of branching banks — and responded well to the agricultural crisis by consolidating banks and expanding branching systems, where this was allowed."

Consider an example from the Fifth District: South Carolina. Its economy, like those of other primarily agricultural states, was hurt by the drop in farm prices during the 1920s. But its banking system stood up relatively well — as did the banking systems in most other states that permitted branch banking.

The success of branch banking may seem counterintuitive. It might appear that a bank with branches spread throughout a region is especially risky since that bank often has more to lose than a bank with just one office. But the very fact that a bank has a large and diversified portfolio actually enhances its stability. Its risk is spread over a wider pool, meaning that if business is ailing in one area, others may remain healthy.

In contrast, the more geographically concentrated a bank's depositor base and lending clientele, the more risk it faces. In such a world, if one segment of its customers is facing problems, it's likely that other parts are as well. This can put a bank under severe, and perhaps fatal, pressure — and is arguably what happened to many banks during the 1930s.

So, overall, I think that we should look at the deregulation of the banking industry and the resulting rise of interstate branch banking as a welcome occurrence. The U.S. financial system, I believe, will become more efficient over time. And for the reasons I have discussed, I think it also will become more stable. Both are healthy trends for consumers.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND

Inflation Targeting

BY JENNIFER WANG

The debate over best-practice monetary policy is escalating: Will it be rule-based or discretionary?

In January of 1995, the Federal Open Market Committee (FOMC) held a debate on inflation targeting. Al Broaddus, then-president of the Richmond Fed, presented arguments in favor of inflation targeting, while Governor Janet Yellen (now president of the Federal Reserve Bank of San Francisco) provided the counterarguments. The debate ended with Chairman Alan Greenspan declaring the Committee “as split down the middle as we could possibly get.”

A decade later, the issue of inflation targeting continues to spark discussion within the Federal Reserve System. The topic remains as controversial as ever, and as Greenspan’s current and final term draws nearer to its February 2006 end date, the topic will no doubt receive additional attention.

Since 1979, the Fed has vigorously pursued a policy of price stability, first under Chairman Paul Volcker, and now under Chairman Greenspan. But uncertainty over Greenspan’s successor causes some to fear that discretionary power in the wrong hands may reverse the work done in the last 25 years.

The proposed solution? An inflation targeting framework for monetary policy.

While inflation levels are stable, advocates of an inflation targeting framework want to set a few guidelines

to institutionalize monetary policy. They believe implementing a formal inflation target will cement the hard-won gains of price stability throughout leadership transitions. On the other hand, opponents of inflation targeting deem it unwise to tamper with a discretionary policy that has thus far proven so successful.

So the question the Fed appears to be asking itself is: Which will better stand the test of time — rules or discretion?

The What, How, and Why of Inflation Targeting

What does the term “inflation targeting” mean? Marvin Goodfriend, senior vice president and policy advisor at the Richmond Fed, defines inflation targeting as “a framework for monetary policy characterized by the announcement of an official target for the inflation rate and by an acknowledgement that low inflation is a priority for monetary policy.”

To implement an inflation targeting framework, the Fed must first declare a specific numerical target (or range) for inflation, which is measured by a price index such as the CPI or the PCE. The Fed would then pledge to achieve and maintain inflation within these bounds over a stated time horizon.

Theoretically, through improved communication with the markets, and repeated success in attaining target objectives, an inflation targeting framework would lead to increased transparency and credibility for the central bank, fostering an environment conducive to sustained price stability and economic growth.

Looking briefly at monetary policy abroad over the past 15 years, it is not difficult to see why a proposal to put inflation targeting in practice is so compelling. In December of 1989, the New Zealand Parliament codified inflation targeting as the country’s

Bank of England Governor Mervyn King (left) talks with U.S. Federal Reserve Chairman Alan Greenspan (center) and the President of the European Central Bank, Jean Claude Trichet (right), at the 2004 G20 conference in Berlin. The Bank of England has adopted an inflation targeting framework, while the Fed and the ECB remain undecided.



PHOTOGRAPHY: AP/WIDE WORLD

framework for conducting monetary policy. Since then, 20 other countries — including industrial, transitional, and even developing economies — have adopted similar legislation with some degree of success (see table).

In the United States, during the period known as the Volcker disinflation (1979 to '87), the Fed brought down core inflation from 10 percent to 4 percent. Subsequently, inflation has remained low and relatively stable. Pursuing “hawkish” inflation policies also led the Volcker-Greenspan Fed to more elusive, unquantifiable accomplishments like the reestablishment of central bank credibility and a restored faith in the Fed’s commitment to low inflation.

Indeed, Goodfriend and others have argued that although the Fed has never explicitly employed inflation targeting, it has long done so implicitly. Goodfriend, a strong supporter of inflation targeting within the Federal Reserve System, summarizes his case: “When one considers the Greenspan era as a whole, it would appear that the Greenspan Fed adopted, gradually and implicitly, an approach to monetary policy that can be characterized as inflation targeting.” The question becomes: Should the Fed take the next step and declare an explicit inflation target?

Yes ...

Supporters of inflation targeting say it would generate two significant advantages over the status quo. Mickey Levy, chief economist at Bank of America, identifies one of the main benefits: more clarity regarding policy decisions. “I think a lot of the difficulty or confusion the Fed has had over its announcements about monetary policy would evaporate if the Fed had a properly stated monetary policy or inflation guideline,” Levy says. With inflation targeting, “I think the issue of transparency becomes much more straightforward, which would help the Fed avoid some of the problems it’s run into in the last few years.”

Frederic Mishkin, a professor of banking and financial institutions at Columbia University’s Business School,

was an early champion of inflation targeting. Mishkin articulates the second advantage: Policymaking would become less dependent on a chairman’s personal philosophy. “We have as strong a nominal anchor as any country that has announced inflation targeting. The problem is that nominal anchor is embodied in Chairman Greenspan.” Left alone, this strategy could prove dangerous.

“Putting in an inflation targeting regime is, in a sense, trying to provide a succession plan for Greenspan,” Mishkin suggests. “We’d like to clone Greenspan. We can’t. But what we would like to do is imbibe a future policy framework with the basic principles [of price stability] in which he has operated.”

Results from countries that practice inflation targeting have been generally positive. Across the board, average inflation has dropped significantly after an inflation-targeting policy was adopted. In the United Kingdom, for example, inflation fluctuated wildly until the adoption of inflation targeting in 1992. Since then, inflation has been brought down to manageable levels for the first time in many decades.

But inflation targeting is certainly no magic wand, and supporters stress that it should be viewed as a framework or set of guidelines — not a rigid rule. Mervyn King of the Bank of England has been careful to point out that inflation targeting is “a way of thinking about policy. It isn’t an automatic answer to all the difficult policy questions.”

Supporters of inflation targeting believe a policy change will be easiest to implement while inflation is already low, and the public and markets are familiar with the approach. Even Congress is thinking about it.

Robert Keleher, chief macroeconomist of the Joint Economic Committee of the U.S. Congress, has argued that inflation targeting would have the effect of “institutionalizing and depersonalizing the goal of price stability.” This, he says, “will help ensure that Federal Reserve performance depends more on a transparent

system of rules rather than upon the vagaries of individuals, and is less prone to political manipulation or pressure.”

... Or No?

On the other side of the fence, skeptics of inflation targeting, including many economists within the Fed, believe there would be a number of disadvantages associated with the adoption of an inflation targeting framework.

The first and most frequently discussed issue pertains to the advantage of having policymaking flexibility within a discretionary framework. Federal Reserve Board Governor Donald Kohn agrees the Fed has conducted policy with an eye on long-run price stability, but is not convinced that recent success is due to implicit inflation targeting. Rather, it is derived in large part from the Fed’s “ability to adapt to changing conditions — a flexibility that likely has benefited from the absence of an inflation target.”

Thomas Schlesinger, executive director of the Financial Markets Center and a vocal critic of inflation targeting, says that the evidence from abroad is not as clear as supporters of inflation targeting might suggest. Schlesinger cites a paper by Laurence Ball and Niamh Sheridan that concludes that after factoring in regressions to the mean, there is “no evidence that inflation targeting improves performance as measured by the behavior of inflation, output or interest rates.”

Schlesinger identifies another reason why an inflation targeting model might prove inadequate: “It ignores obvious and important questions about financial stability problems that can occur in a low inflation regime,” he says. “The evidence indicates ... that managing the economy in periods of sustained low inflation can be just as tricky, if not trickier, than achieving the goal of price stability. We’ve seen that asset bubbles and busts can and have occurred in periods of sustained low inflation.”

Finally, skeptics of inflation targeting argue that adopting an inflation target is simply unnecessary. The United

States has done well without inflation targeting, they say, and it is hard to justify a policy change when there is little evidence to suggest the economy would profit more under a different regime — particularly since credibility could erode if the Fed fails to achieve its target range. Moreover, there are less drastic alternatives available to increase policy transparency, such as earlier releases of records and forecasts.

Rules vs. Discretion in a Post-Greenspan Fed

Mark Gertler, chairman and professor of the economics department at NYU, believes that inflation targeting is

“useful for central banks in transition to price stability. But in the United States, I don’t know why we would be worse off one way or the other.”

The ambiguity inherent in Gertler’s statement echoes the sentiments of economists in the banking and financial services industries who think that it is still too early to tell.

Stuart Hoffman, chief economist at PNC Financial Services Group, thinks an explicit inflation targeting framework won’t happen for a while. The most basic details have yet to be worked out — down to which inflation measure to use, and what the appropriate ranges would be for a target. Hoffman also alludes to the trouble of

establishing a time period for an inflation target, and the need to define a coping strategy should the inflation rate move toward the ends of a target range.

Although Hoffman acknowledges that such a change will be difficult to implement, he remains hopeful. “I think the market would benefit from some explicit inflation target framework from the Fed,” he says. “It would be a learning process for the Fed. It would be a learning process for the markets. But I think it would be a good discipline, and I do think it might help to anchor public and market inflation expectations.”

When asked to speculate about the future look of a post-Greenspan Fed, Bank of America’s Mickey Levy replies with optimism. “Anything can happen, but the Federal Reserve and the whole of the financial community recognize the economic benefits of stable low inflation, and so even under a new Fed regime with a new chair, the impetus is toward continuity, and the policy thrust toward stable low inflation.”

Ultimately, the decision of implementing inflation targeting can be thought of as a choice between stability or flexibility, rules or discretion.

“You don’t want to adopt a policy or not adopt a policy because of current circumstances. You want to adopt a policy that works under all sorts of circumstances — not just in times of economic depression or economic prosperity,” cautions Joel Naroff, chief economist for Commerce Bank. “My view is that either the policy is correct to be implemented under all sets of circumstances, or it shouldn’t be implemented at all.” **RF**

Does Inflation Targeting Work?

Average inflation rates have fallen more rapidly in countries with inflation targeting (IT) regimes, but they have also had more room for improvement.

Sample IT Countries	Year IT Began	1980 to 1989	1990 to 1999	1998 to 2001
Australia	1994	8.4	2.5	2.8
Canada	1991	6.5	2.2	2.0
Chile	1991	21.2	11.5	4.0
Israel	1992	104.7	11.2	3.2
South Korea	1998	8.1	5.7	3.6
New Zealand	1990	11.8	2.1	1.6
Poland	1998	43.0	52.0	8.6
Sweden	1993	7.9	3.2	0.9
United Kingdom	1992	7.4	3.7	2.4
Sample Non-IT Countries				
Japan	-	2.5	1.2	-0.3
United States	-	5.5	3.0	2.5
Euro area	-	6.6	2.8	1.8

SOURCE: Bank for International Settlements

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Big Changes for Regional Manufacturing and Tobacco Sectors

BY CHARLES GERENA

President Bush signed the American Jobs Creation Act on the eve of his 2004 re-election. Among other things, the legislation contains accounting changes and tax breaks intended to benefit various sectors of the national economy, from restaurant owners to producers of biodiesel fuel. It may even stave off a trade war by repealing a tax break on the export income of manufacturers called an extraterritorial income exclusion (ETI). The ETI had angered the European Union enough to impose tariffs on U.S. exports last March.

The Jobs Creation Act will affect two bedrocks of the Fifth District regional economy: manufacturing and tobacco.

Hello, Tax Deduction

While some manufacturers lose the ETI, many more will gain from the cornucopia of provisions in the Jobs Creation Act. For one thing, they will receive more than \$8 billion of tax breaks over the next three years to offset the impact of the ETI repeal.

In addition, manufacturers will be able to deduct 9 percent of gross income generated by “domestic production activities,” minus certain items. The deduction phases in over the next five years.

The bill’s definition of “domestic production activities” includes commodities that aren’t traditionally considered manufactured goods, including construction projects, television shows, and electricity. While this broad description is meant to spread the benefits of the deduction widely, it also adds confusion to an already convoluted tax code.

“You are going to create incentives to label activities within the firm as production that may or may not be production. That’s going to lead to a lot of paperwork for the IRS and the accountants,” says Kimberly Clausing, an economist and tax policy expert at Reed College who has closely studied the provisions of the Jobs Creation Act. Indeed, PricewaterhouseCoopers expressed its concerns about the uncertainties surrounding the deduction in a recent report to its clients.

Clausing thinks it makes little sense to stimulate the economy by creating yet another deduction. Instead, tax simplification and a reduction in corporate tax rates would be better, she says. “You wouldn’t be handing well-connected people windfalls. You would generate economic activity

because the marginal incentive to do things is going to be higher when our rate is lower relative to our foreign counterparts.”

Bye-Bye, Price Supports

In the Fifth District, the provision of the Jobs Creation Act that has garnered the most attention has been the “Fair and Equitable Tobacco Reform Act,” which eliminates federal price supports and the quota system that controls tobacco leaf production. To soften the blow, quota holders and tobacco growers will receive annual payments over the next 10 years, up to a maximum of \$9.6 billion.

The tobacco subsidy program began during the Great Depression to help farmers cope with falling prices. Since

then, it has succeeded in keeping domestic tobacco prices up and domestic production down, says economist Richard Ault at Auburn University. That hasn’t been good for tobacco product manufacturers because they want greater flexibility and more stability in their supply.

Higher tobacco prices also “created an incentive and an opportunity for imported tobacco to come into the market,” Ault says. “In the last 20 years, other countries have developed tobacco that is a very good substitute for high-quality American tobacco, particularly Brazil.” As U.S. tobacco production has fallen and quotas have been lowered, quota holders have watched their assets diminish in value. Ault says that is why they have been anxious to be bought out by Uncle Sam.

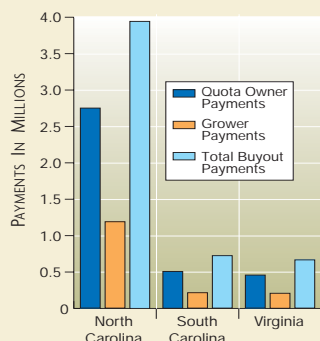
As for farmers, those who hold quotas will immediately benefit from

the annual payments they will receive. Also, they will no longer have to buy or rent quotas to increase production. But some may see the value of their land drop because plots with tobacco quotas associated with them commanded a premium that no longer exists. Eliminating tobacco subsidies will also remove a major justification for the warehouse-based auction system, which offers farmers an alternative to direct contracts with manufacturers. Only tobacco sold at auction is eligible for price supports, not tobacco sold under contract.

The transition might be painful for some, but economists like Ault believe that agricultural subsidies can’t work in a global economy. “All countries are finding that, in the face of foreign competition, subsidy programs are becoming more and more burdensome,” he says. **RF**

The Big Tobacco Payoff

North Carolina will get the biggest chunk of the federal tobacco buyout: 41 percent of the \$9.6 billion total payout over the next 10 years. Maryland wasn’t included in the buyout, while West Virginia received very little money.



NOTE: Adding owner payments and grower payments may not equal total buyout payments due to rounding.
SOURCE: Agricultural Policy Analysis Center, University of Tennessee

Sunk Cost

BY ERIC NIELSEN

Suppose the local theater is putting on a production of your favorite play. In anticipation of the event, you order tickets ahead of time for the second performance. Unfortunately, your best friend sees the play on opening night and tells you that it is awful and no one with any judgment would enjoy it. You now are in a bind because the ticket you purchased is nonrefundable, and you really do not want to see the play. What should you do?

Many people would go to see the play anyway, so as not to waste the price they paid for the ticket. This is a very natural psychological reaction that economists call “loss aversion.” People do not like to feel that they have spent money for no reason. However, natural as it may be, basing decisions on irrevocable past expenditures is a classic example of the “sunk cost” fallacy.

Economically speaking, a sunk cost is an expense that has already been incurred and cannot be recovered. For example, the theater ticket above is a sunk cost because it has already been purchased and cannot be refunded or easily resold.

Advertising expenses are another example of a sunk cost. Let’s say you invest \$1 million promoting a new product but find out that few people are interested in actually buying it. You could continue to pump money into hawking the good — not wanting to admit failure — or you could move on and promote a different product. Either way, you won’t be able to recover that initial \$1 million investment. It is a sunk cost.

Sunk costs are contrasted with incremental costs. An incremental cost is one that will change with a particular course of action. For example, when you are at the grocery store deciding what and how much to buy, the decision to purchase an extra loaf of bread involves an incremental cost. The expense of the bread will be incurred only if you decide to buy it.

A rational economic actor considers only incremental costs when making a decision. It makes no sense to factor in sunk costs precisely because they are sunk; no present action can change them. No matter what happens, the sunk costs are always there. In the theater example, you can either

go to the play or skip it. If you go, you will pay for the ticket and waste a few hours. If you do not go, you will still pay for the ticket and possibly spend the time doing something more enjoyable or productive. No matter what you do, you pay for the ticket so it makes more sense not to go and enjoy yourself instead.

Though the above example may appear relatively harmless, the natural human tendency to consider sunk costs in decisionmaking can have major policy implications. Just like people, businesses and government are often loathe to admit they made a mistake, cut their losses, and start anew. This tendency to hold on to failing programs too long may be especially acute in the public sector since the profit incentive is muted or nonexistent.

Ultimately, if a business refuses to admit it has made a mistake, it will go out of business or become significantly less competitive. Governments face little or no such competition to perform efficiently.

The United States is currently engaged in military action in Iraq — and there are strong arguments from many sides on how we should proceed. For example, some have argued that we should withdraw carefully from the region

now, while others maintain that we should stay until the area is fully stabilized. It’s not clear which side is correct.

What is clear, though, is that U.S. policymakers should weigh only the benefits and costs of leaving at the present moment. The time and money that have already been spent are sunk costs and should not be considered. It might be best for us to stay, but the fact that we are already there is not a reason for us to remain. To argue that we should finish what we started — no matter the consequences — would be to fall prey to the sunk-cost fallacy.

Costs are everywhere in life. Indeed, economics teaches us that they are unavoidable. So it is natural and rational to consider the costs of an action before proceeding. But we should be careful to focus on those costs we can affect at the present — and not on the sunk costs that we have already incurred. Focusing on sunk costs is ultimately counterproductive and can only be justified through our psychological prejudices. Still, the urge to do so is strong, and explains why the practice is common among both consumers and policymakers. **RF**



Is Good Journalism Good Business?

BY DOUG CAMPBELL

In 2003, the *Washington Post* won three Pulitzer Prizes, more than any other newspaper in the nation save for the *Los Angeles Times*, which also collected three. For the reporters and photographers whose names were on the winning entries, the significance cannot be overstated: Pulitzers are journalism's highest honor. The winners can expect greater pay and prestige — and almost certain career advancement.

The payoff for the *Post* as an institution isn't bad, either. Pulitzers may be a big part of the reason why the *Post* sells so many papers — more than 1 million on Sundays to be exact, the fifth highest total in the country.

In their recent article, “Newspaper Quality, Pulitzer Prizes, and Newspaper Circulation,” University of Oklahoma economists Brian Logan and Daniel Sutter test whether good journalism is also good business. Their study shows that U.S. consumers have a healthy appetite for “quality” journalism. In newspapers, the authors conclude, quality still sells.

Journalism became an increasingly ripe topic for economic inquiry in the 1980s and 1990s as media companies consolidated their empires. There were worries that profits would come before quality. Sociologists David Crouteau of Virginia Commonwealth University and William Hoynes of Vassar College wrote that there was increased “emphasis on revenue, margins, profits, and stock-price performance, forcing the companies to emphasize the aspects of newspaper operation that directly produce those results.” Profit-maximizing media companies, the watchdogs warned, would seek to trim staff and deliver advertiser-friendly news — not the sort of “quality” attributes traditionally associated with the noble Fourth Estate.

Sutter has looked at journalism through an economic lens before. In a 2001 paper published in the *Cato Journal*, he addressed the conventional wisdom that the news media as a whole tilts left. While he concedes that there is good evidence to support that claim — in surveys, a large majority of journalists at top media outlets identify as being left of center — it's not clear that such bias is sustainable. That would require a cartel — and cartels are notoriously unstable, with defection a constant threat. In the case of the media, new technologies are lowering the cost of entry, making it even easier for conservative voices to be heard. Over time, well-functioning markets should provide a wide variety of choices for media consumers.

In their new study, Logan and Sutter also look to the marketplace, this time for quantifiable answers about the appeal of quality journalism. They chose Pulitzers as their gauge on the premise that the prizes bridge the gap between consumers' and journalists' perceptions of quality. They write: “Pulitzer Prizes are a measure of quality as judged by journalists which consumers can easily observe and thus, provide an opportunity to determine whether news consumers value what journalists consider high-quality journalism.”

The results are compelling. Logan and Sutter examined daily and Sunday circulation of the nation's largest 400 newspapers in 1997. They found that papers which had won Pulitzers during the preceding decade had “significantly higher circulation, even when controlling for the economic and demographic characteristics and media competition of the metropolitan areas.” In fact, daily circulation was found to be 55 percent higher for Pulitzer winners than their empty-handed counterparts.

The top winners in the years from 1987 to 1997 were among the 10 largest in U.S. daily circulation: the *New York Times* with 18 prizes, the *Washington Post* with 14, and the *Philadelphia Inquirer* with 11.

A few holes remain. In claiming that the biggest are also the best, the authors don't explain the anomaly of *USA Today*, whose unparalleled growth has made it the nation's largest paper with

circulation of more than 2.2 million. At the same time, *USA Today's* record in winning Pulitzers has been paltry, with just one in its entire history. And as Logan and Sutter note, *USA Today* is regularly derided in journalism circles as “McPaper.” Nor do the authors address broader circulation trends, in which even prize-winning newspapers are losing eyeballs to cable TV and the Internet, which are not always bound by the same standards as print journalism.

Still, Logan and Sutter make a strong case that publishing good newspapers is good business. Papers that provide quality content usually attract wider audiences, which means greater revenue. More revenues don't necessarily mean more profitability, but it's a fine start. “Quality may well pay,” they conclude. “If quality produces a larger audience, owners of media companies can rationally invest in quality journalism.” In a country that depends upon the free flow of quality information for the proper functioning of its government and economy, that's good news. **RF**

“Newspaper Quality, Pulitzer Prizes, and Newspaper Circulation”
by Brian Logan and Daniel Sutter.
Atlantic Economic Journal,
June 2004, vol. 32, no. 2, pp. 100-112.

FINANCIAL AID

Decentralizing Virginia's Public Universities

The budget crisis that swept through most state capitals the past three years took its toll on higher education funding, pushing public universities to find ways to cope with budget shortfalls. Tuition rates have increased as much as 125 percent since 1990, and many institutions have sought additional funds through corporate partnerships. A few public universities have even privatized.

The Fifth District is no exception. To counter a shrinking state budget, the University of Virginia, the College of William and Mary, and Virginia Tech have engineered the "Commonwealth Charter Universities Initiative," a legislative proposal that would grant the institutions more autonomy in exchange for less state funding.

In other words, after the 2005 General Assembly, these three public universities may get charter status — no longer public, but not technically private, either. By giving up a percentage of future state funding, a chartered university would be granted greater freedom over its finances — including the flexibility to raise tuition as its Board of Visitors sees fit. Increased autonomy also would significantly reduce the inefficiency and expense associated with bureaucratic regulation.

Though they would no longer be state agencies, the universities would not be private institutions either. According to Virginia Tech President Charles W. Steger, as quasi-independent "political subdivisions," chartered universities would remain "public institutions with boards of visitors appointed by the governor, confirmed by the General Assembly, and accountable to the commonwealth."

L. F. Payne, a member of the Board of Visitors at UVA, believes the Charter Initiative is absolutely necessary. UVA's state appropriation is "by far the lowest as a percentage of any state university of the nation, and that number continues to decrease." With charter status, UVA will better be able to meet future financial challenges, and "stay a top-quality university and provide the high-quality education that kids in Virginia and other places are demanding.

"I think the beneficiaries of this will be the employees, the faculty, the students, and the institutions," Payne says. "It seems to me they're all winners."

But not everyone feels like a winner. The Charter Initiative proposes big changes that will affect many parties, and not all the changes will provide clear benefits.

For students, less state money means tuition may go up considerably. However, all three universities plan to exercise some of their new freedom by implementing financial aid programs that will meet the needs of their students. UVA, for example, will introduce Access UVA, which university officials expect will actually increase the number of Virginians (currently two-thirds of the student body) able to attend UVA.

Jan Cornell, president of the Staff Union at UVA (SUUVA), regards the Charter Initiative with little enthusiasm. She has many reservations over the terms of future personnel policies if UVA becomes chartered.

"I understand the problem — the state is not giving them enough money. I totally agree with that, but ... I don't think [pulling away] is the answer to the funding problem. The reasons for pulling out allow them to have freedoms that aren't necessarily good for the employees."

Cornell's concerns are the result of observing employee experiences at UVA's Medical Center, which

gained autonomy in 1996. "We've seen what happened to them. And that's why we're so against it now," Cornell says. Tremendous turnover rates, depressed wages, and inadequate working conditions are cited to have characterized the years following the privatization of the Medical Center.

The administration's actions during the past year have failed to alleviate Cornell's frustrations that history may repeat itself. "When this all started,

Leonard Sandridge said that the employee input would be critical when they were writing the plan ... [but] nobody came to any employee or faculty member to find out what [we] thought about it before they wrote the plan."

SUUVA's worries are exacerbated because definitive answers concerning wages and working conditions are hard to come by. "Unfortunately, there can't be any guarantees," says Payne. "No one has enough information to be able to say precisely what we can guarantee at this point. ... But the institution is no better than the people who are there ... and



University of Virginia's famed Rotunda. A statue of Jefferson stands as a reminder of his founding ideal of an "academical village."

the idea is that [the charter] will ... be able to improve the compensation and benefits for employees.”

Fortunately, UVA has a second model of decentralization to draw on. With the approval of the “Financial Self Sufficiency” agreement, the Darden Graduate School of Business Administration gained financial autonomy from UVA in 1998, under the tenure of ex-dean Edward A. Snyder.

“I can state for the record that the Financial Self Sufficiency [agreement] we developed ... was important, and in my view, successful,” says Snyder, who is now dean at the University of Chicago Graduate School of Business. “Without this agreement, Darden could not have made the decision to grow its MBA program; it hadn’t done so in over two decades.” While some argue Darden’s goal is now the pursuit of money at the cost of learning, there is no arguing with Darden’s performance in *Business Week*’s annual rankings of MBA programs; UVA has risen dramatically since the change.

“I know enough about UVA to say that reform is needed,” says Snyder.

According to Kevin Hall, Virginia Gov. Mark Warner’s deputy press secretary, “The Governor ... expects this to be one of the more high-profile issues [in 2005] when the legislature convenes. It’s a discussion that’s not going to be resolved quickly.”

There is a lot riding on the progress of the Charter proposal. “[It is] such a fundamental shift in the status of the institutions which enjoyed world-class reputations based on decades — if not hundreds of years — of support from the commonwealth of Virginia,” Hall declares.

While a charter is certainly a method that holds a lot of promise for students, employees, and the commonwealth as a whole, what remains to be seen is if these universities can prove that their new financial freedoms won’t adversely affect Jefferson’s founding ideal of an “academical village,” dedicated to the values of an open and diverse intellectual community.

— JENNIFER WANG

DOLLARS FOR DELL

Incentives Help Lure Company to Winston-Salem

Computer maker Dell Inc. grabbed headlines in North Carolina last fall for accepting what was billed as the largest incentive package in state history — \$242 million in tax credits, grants, and infrastructure improvements. In return, the Austin, Texas-based firm promised to spend \$100 million building a manufacturing plant on the outskirts of Winston-Salem that will employ at least 1,200 people within five years. (In addition to the state incentives, Dell was set to reap \$37.2 million in local city and county incentives.)

The Triad metro area, of which Winston-Salem is a part, has been among the worst hit manufacturing regions in the nation, losing about 40,000 such jobs over the past decade. Still, the Triad’s unemployment rate has not risen sharply; it

stood at 4.8 percent last fall. Dell said it chose the region not so much for the incentives package as it did for its skilled pool of manufacturing workers and strategic location. This gave rise to complaints that the Dell incentives were overly generous, especially in light of news uncovered by the *Raleigh News & Observer* that a relatively small bid by Virginia posed the only competition to North Carolina.

Ray Owens, an economist at the Federal Reserve Bank of Richmond, has studied the wider issue of whether corporate incentives make sense. He came away with an answer that may surprise critics of incentives: They can sometimes serve a greater good. Whether that’s the case with Dell’s deal in North Carolina won’t be known for a while.

Owens says that in some cases incentives can make a difference in luring companies to regions where workers are in desperate need of jobs, and as a result both the organization and the economically struggling community benefits. “Incentives can be costly, but you can end up with a net benefit to the state and even nation as a whole,” Owens says.

Where the matter gets fuzzy is in estimating both the deal’s actual costs and benefits in dollars. For starters, calling the Dell agreement a \$242 million package isn’t accurate, Owens says. The various perks being offered to Dell are rolled out over 15 years, and in 15 years the value of a portion of those resources won’t be worth the same as in today’s dollar terms. On the flip side, take with a grain of salt the governor’s and Commerce Department’s assertion that new taxes generated by the new plant will rise to \$743 million.

“I don’t think you can say out of hand that it’s a bad deal for North Carolina. At the same time, you can’t declare it a slam dunk deal,” Owens says. “It’s not clear who’s right or wrong. But it is fair to say that all these dollar estimates have a lot of uncertainty associated with them.” — DOUG CAMPBELL

HIGH-END HOLDOUT

Northeast Textile Maker Finally Migrates South

Amid thousands of job losses in South Carolina’s textile industry over the past decade, there is one small bright spot on the horizon. Scalamanré, a New York City-based luxury fabrics producer that was one of the few textile firms remaining in the Northeast, will be bringing 90 jobs to the Palmetto State this year. Many companies before it have migrated south since the turn of the 20th century in pursuit of inexpensive labor and other economic advantages. After 75 years, Scalamanré is finally moving from an old brick building in Queens to a more modern facility in Gaffney, S.C., for the same reason.

The company weaves silk and other fine materials into handmade fabrics, which are crafted into drapery, wall coverings, upholstery, and other furnishings. Its products adorn public and private spaces throughout the United States, from the White House to the Metropolitan Opera House to Thomas Jefferson’s home, Monticello. Yet even

a producer of such high-end, specialty textiles — some of which are sold to designers for as much as \$2,000 a yard — eventually had to look at lowering costs and maximizing efficiency just as producers of commodity-type textiles have done for years.

For Mark Bitter, Scalamandr 's co-president, this meant relocating most of the company's manufacturing operations out of New York City. "Our gross margins were such that we could ... tolerate the high labor and occupancy costs far better than most textile producers who make commodity-type products," Bitter says. But the company's sales volume has fallen, partly due to a drop in luxury purchases after the Sept. 11 terrorist attacks and partly due to growing global competition.

"The only way we could compete effectively was by availing ourselves of the absolute best technology to produce the finest quality at the lowest cost," he says. "There is a limit to what even luxury buyers are willing to spend on products."

Why didn't Scalamandr  just modernize its Queens facility? The company needed 150,000 to 200,000 square feet of manufacturing space spread out horizontally on one level, but had only 115,000 square feet stacked on multiple floors. It couldn't tear the existing building down or relocate elsewhere in New York City because land is expensive and limited in supply, and many commercial buildings are vertically oriented.

In contrast, Gaffney and other parts of Upstate South Carolina have few densely populated communities, so there is plenty of open space. For instance, the building that Scalamandr  will move into is a former textile facility measuring 350,000 square feet. And the company will save 60 percent to 70 percent on its occupancy and related expenses, according to Bitter.

He also expects to reduce per-unit labor costs by 40 percent. Most of the Queens facility's laborers had worked there for 10 years or more, putting them at a higher union pay rate. Moreover, the Gaffney facility will tap into a labor market in Cherokee County where the unemployment rate last September hit 9.6 percent, almost three points higher than the statewide rate.

However, even Bitter knows that these cost savings may not be enough to keep his company from turning to outsourcing overseas. Scalamandr  will also have to continue to innovate and improve the quality of its goods. As for textile workers in South Carolina, they will have 90 more jobs available to keep them in the industry that is in their blood. But while that employment figure could double in the future, it still falls short of the 480 positions that used to exist at the Gaffney plant before National Textiles shut it down in 2001. In short, economic forces will continue to challenge America's textile industry to be leaner and meaner.

— CHARLES GERENA

INSOURCING

Foreign Firms Set Up Shop in America

Amid the alarm over the rampant outsourcing of American jobs to countries abroad, a lobbying group for foreign companies would like to call your attention to a contrary trend: insourcing.

The Organization for International Investment (OFII) says that foreign firms employ 5.4 million people in this nation, or 5 percent of private sector jobs. Four states in the Fifth District rank in the top 20 for having the greatest number of jobs that are "insourced," bankrolled by U.S. units of foreign companies. North Carolina has 212,700 such insourced occupations, the OFII says, placing it at No. 9 in the country. Other top-rankers include Virginia (No. 13 with 146,400 jobs), South Carolina (No. 16 with 123,400 jobs) and Maryland, (No. 19 with 106,300). Not surprisingly, California topped all states with 616,400 insourced jobs.

The OFII claims that foreign firms pay U.S. employees "higher compensation than domestic U.S. firms." They are also active in funding research and development, physical facilities (which add to tax bases) and international trade (goods made in the United States are de facto domestic exports, no matter that they were made under the auspices of foreign firms).

"The bottom line is that insourcing companies improve the performance of the U.S. economy," writes Matthew J. Slaughter, a professor at the Tuck School of Business at Dartmouth College, and author of the OFII's report. "It is important that government

officials and the business community understand the contribution of insourcing companies, and that these officials formulate policy accordingly."

In other words: Don't make it harder for foreign firms to locate here. Among the policy recommendations OFII presses at the report's conclusion is to ensure equitable treatment of insourcing companies. "For insourcing companies to continue expanding in the United States, they must know they will receive nondiscriminatory treatment under U.S. law." Equally, the group calls for liberalized trade and investment rules. Otherwise, OFII warns, the United States could lose many of these insourced jobs to India and China. Sound familiar?

Back in the late 1980s, University of South Carolina economist Douglas Woodward co-wrote a book about insourcing called *The New Competitors: How Foreign Investors Are Changing the U.S.* His conclusion then and now remains the same: Insourcing is imperative in a time of outsourcing, and there are few disadvantages to having



German automaker BMW's manufacturing plant in Greer, S.C., has created 17,000 jobs, directly and indirectly, since opening in the mid-1990s.

foreign companies employ U.S. workers versus having U.S. companies employ them.

“Multinational corporations have competitive advantages they can bring to an area that certainly go beyond job creation,” Woodward says. “They bring in new management expertise and techniques. They infuse a region with more competitive practices. Every area successful in the world, from Ireland, Singapore and even less developed nations like Costa Rica — for them foreign direct investment has been a major driving force in moving their economy forward.”

In South Carolina, the 1992 decision by German automaker BMW to build a plant has resulted in 17,000 jobs, directly and indirectly, Woodward says, somewhat offsetting the painful losses in local textile jobs to low-cost countries and new technology.

The large appetite of U.S. consumers serves as potent draw to foreign firms but more can always be done. Providing educated and skilled workforces along with good roads, airports, and sea ports is crucial, Woodward says. Strong incentive programs can also make a difference, he says.

And then there’s the sliding value of the U.S. dollar. “If I were a state or local economic development official, I’d be beating down the door in Europe to say look at how cheap it is to get into the U.S. market,” Woodward says. “If they want to take advantage of this opportunity, there couldn’t be a better time.”

— DOUG CAMPBELL

BLUE CRAB RANCHING

Restoring the Chesapeake Bay’s Most Valuable Commodity

Fifth District researchers are pursuing a new approach to helping the blue crab, a symbol of the Chesapeake Bay and its most valuable seafood product. By boosting the bay’s breeding stock with young crabs hatched and raised in captivity, they hope to reverse a decades-long decline in the overall crab population. If their experiment succeeds, watermen in Maryland and Virginia could take nature into their own hands to help safeguard their economic futures.

Restocking programs have been used to revive marine populations many times, from salmon on the West Coast to trout in the Great Lakes. But such programs are rare for crustaceans and other species with a high rate of reproduction. Since their offspring have a low probability of survival, these creatures produce millions of larvae, thus making any restocking effort difficult.

“Blue crabs spawn in the southern part of the bay and the eggs are hatched offshore in the [Atlantic] Ocean,” says Douglas Lipton, a University of Mary-

Watermen may soon cultivate and release these juvenile blue crabs to restock the Chesapeake Bay.



land economist who contributes to the Chesapeake Bay Commission’s Blue Crab Technical Work Group. “They have to survive that and get back into the bay, find nursery grounds and survive being eaten by all sorts of fish in order to become an adult.”

Therefore, any effort to restock the blue crab population has to go beyond just hatching eggs, dumping larvae into the ocean, and hoping for the best. Japanese scientists released tens of millions of larvae to boost the number of swimming crabs for almost 20 years, until they realized that it probably wasn’t working. In the 1990s, they started raising crabs to an older age before releasing them in order to give them a better chance of staying alive and breeding.

Along with the Smithsonian Environmental Research Center (SERC) and the Virginia Institute of Marine Sciences, researchers at the Center of Marine Biotechnology (COMB) in Maryland took this second step from the very beginning. Using its expertise in spawning, production biology, and the early life stages of marine organisms, COMB converted a basement in downtown Baltimore into a carefully controlled environment where female blue crabs can hatch eggs and the larvae can develop into 2-month-old juvenile crabs.

Juveniles are less than an inch in length and have soft, translucent shells. Since they have bypassed a tough part of their lives in captivity, however, more of them are around to progress from adolescence to sexual maturity. In the last three years, 100,000 juveniles have been released into the Chesapeake Bay. They appear to have a similar survival rate from adolescence to breeding age as native crabs do.

Whether helping nature along will replenish the bay’s blue crab population remains to be seen. The effectiveness of Japan’s restocking efforts has been difficult to gauge due to a lack of data. To judge the progress of blue crab restocking, SERC scientists tag juveniles and track them for up to 14 weeks after their release.

If the restocking approach works, the next step is to modify it so that watermen throughout Chesapeake country can raise crabs and release them on their own. Getting them on board will require continued confidence building on the part of scientists, though. Watermen are traditionally fatalists who believe that nature governs the workings of the bay.

Could watermen be right about letting nature take its course? Allowing the total supply of blue crabs to continue to fall would put upward pressure on prices, which would eventually reduce the quantity of crabs consumed and level off the amount of harvesting. “That is the market working. But what’s happening with the biology? At that point, have you gone past some critical level where the [blue crab] stock will take years to rebuild?” asks Lipton.

— CHARLES GERENA

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branch bonanza

Bank branches, all but given up for dead a decade ago, have kept on growing in numbers through 2004. Analysts say that location, accessibility and even architecture are the keys to a branch's success in collecting deposits.

They cost a lot, but customers can't get enough of them. Why bank branches won't go away

BY DOUG CAMPBELL

This swath of real estate in Leesburg, Va., has everything you would expect in one of the country's hottest job and population markets: upscale strip malls and low-slung office buildings; construction signs and sprawling town-home complexes.

But there's one feature that crystal ball gazers of the 1990s might not have guessed: bank branches. There are nine of them within a half-mile of each other in this Washington, D.C., suburb, together keepers of almost \$600 million in deposits.

What's surprising about this scene is that technological advances were supposed to make bank branches extinct. The telephone, the Internet, and souped-up ATMs — these were the devices through which retail and even some commercial customers would interact with their banks. Bricks and mortar cost too much to build and staff; customers would grow accustomed to conducting transactions in the virtual world.

It didn't happen that way. Across America, more branches are opening than ever — some 2,000 were added

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just last year. Industry giants Bank of America and Wachovia Corp. have unveiled plans to build hundreds of new branches in new and existing territories. As much as bankers would have liked to have stopped building new offices, darn it if customers didn't demand them. Nothing beats the convenience of a neighborhood branch.

Leesburg encapsulates the rising fortunes of bank branching. Instead of seeing branches close their doors in the past decade as banks merged, more branches have opened (although that growth turns out to be anomalous in the Fifth District, a point that we'll address). Be they big or small, the banks that have found the most convenient locations here have been the most likely to ring up market-leading positions in deposits. Branches are central to a bank's success.

The enduring appeal of garden-variety banking offices holds a lesson: Just because there's a supply of new, cost-efficient technology doesn't mean there's an immediate demand. This is not to say that change isn't coming. Online services like bill paying and loan applications are slowly catching on. The shift is just taking a little longer than anticipated, and it's being accomplished mainly because of hand-holding from front-line branch employees.

"There was a feeling, back when the Internet craze was going on, that consumer behavior was going to change, and banks wanted to be out in front of that curve," says Terry Meyer, president of the Raleigh-based consulting firm MarkeTech Systems International. "They wanted to pull cost out of the distribution system. That change was greatly exaggerated."

Premature Death Notices

Branch banking obituaries started appearing in the 1980s. Lawmakers in 1980 lifted Depression-era rules (called Regulation Q) that had placed ceilings on the interest rates banks could offer on savings accounts. One school of thought was that bank branches would have fewer reasons to exist in an environment with no lids on deposit rates; instead of competing branch by branch

to hand out the finest toaster, banks would compete on price.

Contrary to expectations, branch banking continued to grow. State branching laws were slowly being relaxed in the 1980s and 1990s. In 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act removed remaining state restrictions on interstate branching. In addition to opening the door to buying out-of-state institutions, banks could enter new territories with newly chartered "de novo" offices. In the 1980s alone, more than 15,000 branches were added in the United States.

Then came branch banking's second, and seemingly more threatening, death notice. This time the killer was to be technology. Voice mail trees, ATMs, and the Internet would make full-service branches a thing of the past.

Pure-play Internet banks started sprouting up, fueled by enormously efficient cost structures. But they lacked a human touch. Most of these Internet banks failed to make the impact once envisioned, says Elias Awad, the Virginia Bankers Association professor of bank management at the University of Virginia. "People couldn't see themselves having money in an artificial environment," Awad says.

So instead of a virtual banking boom, the growth came in bricks and mortar. The number of bank offices climbed 10.5 percent in the past decade to 89,814. Over the same period the average number of offices per bank leaped from 6.3 to 9.5. All this happened amid rampant banking consolidation, with the number of banking institutions declining almost 50 percent from 1994 to 2004. And it happened despite the strong incentives banks had to curb branch growth. A typical branch costs between \$1.5 million and \$2.5 million to build and then runs up to \$800,000 a year to staff and maintain.

It's a sizable investment, but the payoff is clear. "The economics of it are that it makes sense for banks to branch," says Jack Phelps, acting director for regional operations at the Federal Deposit Insurance Corporation (FDIC). "The people who are doing it

are generally finding it profitable to do so, and that's a little different than what was expected 10 years ago."

Profitable and then some. Banks with more branches are also the most efficient — but not because of economies of scale. The FDIC and Federal Reserve researchers have identified increased revenues, as opposed to reduced costs, as the driver behind efficiency improvements (as measured by the so-called "efficiency ratio," which is calculated by dividing noninterest expenses by the sum of net interest income and noninterest income). From 1970 to 1990, efficiency ratios among U.S. commercial banks were relatively flat, the FDIC found. They began to improve (fall) as the number of banks declined (with mergers) and the numbers of branches grew.

Branches may be costly, but they're a good place to generate revenue. Allen Berger, a senior economist with the Federal Reserve Board of Governors, and Loretta Mester, director of research at the Philadelphia Fed, report in a 2003 paper that banks got so good at selling during the 1990s that they easily offset rising expenses, such as larger branch networks. "Over time, banks have offered wider varieties of financial services," they wrote. "In addition, banks have provided additional convenience."

Phelps says, "People pay attention to costs, but it's on the revenue side where the clear gains are being made."

Even small banks are finding profits in branches. In its branching study the FDIC defined small banks as those with less than \$1 billion in assets. It found that banks with more branches were more efficient — that is, they were able to produce an additional dollar of revenue at lower cost. According to the FDIC, banks with 11 or more branches were the most efficient of the small banks, followed by those with between 10 and four branches, which in turn were more efficient than banks with three or fewer branches. Meanwhile, overall bank efficiency ratios have improved by about 30 percent over the last 20 years, a period that coincides with branching expansion.

Additionally, the FDIC has found that banks of all sizes post higher returns on equity if they have more branches (see chart on page 17).

Super Sites

The economic success or failure of individual branches is almost all about geography.

MarkeTech analyzed the performance of 5,000 young branches in the United States, defined as those around for about 10 years. The key finding was that 70 percent of a branch's success

or failure in collecting deposits was explained by micro-market variables: What other retailers were situated nearby? What competitors were there? How convenient was it to get in and out? Were there traffic lights? How dense was the immediate population?

The upshot: MarkeTech estimated that location explained up to 55 percent of deposit formation. About two out of three banking customers live within two miles of their principal branch.

That's it, folks. Location. Straight out of a circa 1950s real estate how-to manual. Location.

The Federal Reserve has studied why people choose their banks and came back with that same answer. "The single most important factor influencing a customer's choice of banks is the location of the institution's branches," said Federal Reserve Governor Mark Olson in a May 2004 speech. Ranking "location" highest in their decisionmaking were households (43 percent) and small businesses (30 percent), according to Fed surveys in 1998 and 2001.

But bankers should follow their intuition only so far. Retailers instinctively might want to seek out high-growth and affluent areas, but in branch banking that doesn't necessarily equate to performance. "Banks go to growth. They think that's where they'll be most successful," MarkeTech's Meyer says. "But the problem is everybody goes there." In MarkeTech's



Middleburg Bank's branch in Leesburg, Va., is the fastest-growing and biggest banking office, with more than \$140 million in deposits, in fiercely competitive Loudoun County.

analysis, the top performers in "static" markets outdid the top performers in high-growth areas.

Middleburg Branches Out

Which brings us back to Leesburg, Va. According to a MarkeTech analysis, Middleburg Bank's Leesburg branch accomplished the rare feat of being among the top performers of all branches in the Fifth District as well as being located in one of the nation's fastest-growing markets.

It took 70 years for Middleburg Bank — based in Middleburg, Va., a Loudoun County community near Leesburg — to become a convert to the virtues of branching. In 1994 it still kept only its headquarters office and had \$110 million in total deposits for 12.9 percent market share, making it a distant third in Loudoun County. At the end of June 2004, the latest date for which aggregate records are available, Middleburg rode its five offices to deposits of \$418 million, claiming 18.46 percent of the county's market, moving up to a solid hold on the No. 2 spot in the county.

The Leesburg market opened up in the mid-1990s as community banks Farmers & Merchants of Hamilton and Bank of Loudoun were gobbled up by bigger banks. Those two banks commanded \$100 million in deposits, or almost a third of the market. Joe Boling, Middleburg's chairman and

CEO, sized up the opportunity and said: "I just want that \$100 million." In five years, he got it, and he didn't have to pay a premium for another bank to do it. Last year, the Leesburg office, which opened in January 1996, had \$140 million in deposits, most in the city.

Loudoun County is something of a no-brainer as a place to open a bank branch. Since the dawn of the 1990s, the county has seen population grow at a robust 7.5 percent annual clip, the second highest rate in the nation for that period. For

the 12 months ending March 2004, Loudoun County posted a 5.5 percent gain in jobs, sixth fastest in the nation and shattering the U.S. employment growth rate of 0.8 percent. The region has benefited as a bedroom community of Washington, D.C., and is home to many government contractors. New jobs mean new homes and new retailers, which in turn mean mortgages and commercial loans.

Middleburg Bank's Leesburg branch on Catoclin Circle is strategically located near the Dulles toll road, with easy access to neighboring housing units and not far from downtown. Nan Havens, manager of the branch, explains the success: "Location, location, location," Havens says. "It's perfect."

In The Flesh

For now, technology is a lousy tool for accumulating deposits. People are much better. Branching has allowed Middleburg Bank to situate its people within convenient distance of its customers.

The revolutionary strategy: It's easier to sell people products if a) you're talking to them face-to-face; and b) you already do business with them. Likewise, it's even easier if you've found the perfect spot for your branch, as Middleburg Bank seemingly did in Leesburg.

"My belief is that if you can put a strategically placed financial service

center in a core part of a market and you have the right people and the right services, they will come," says Boling. "We're building relationships, not just counting deposits."

Pacing through the carpeted office, branch manager Havens greets several customers by first name. Contractors clad in overalls and mothers toting babies in car seats ease up to the teller stand. At 11 a.m., all three drive-through teller lanes are occupied with cars.

There is very little unique about the space. A basket of toys sits to the side of the teller lines for restless children to play with. There are plans

for a coffee bar, but it's not here yet.

But it works. Branch employees open about 150 new accounts a month, Havens says, and about half of those are for existing clients. In other words, checking account customers are also signing up for insurance, investments, and other financial products. "We're doing a lot of cross-selling," Havens says. "The buzz word for now is relationship banking."

"Folks who thought it was going to go away completely forgot that they needed some touch points," Boling says. "We still like to see each other and we still like to shake hands."

Big Banks Lead The Way

In Leesburg, the city's second-biggest branch, with \$137 million in deposits, is located directly across the street from Middleburg Bank. It belongs to North Carolina-based BB&T.

Where Middleburg Bank has used a rifle approach to branching, BB&T's has been more shotgun. It has poked the county with 12 branches, producing a market-leading \$524 million in deposits, or a 23 percent share. BB&T didn't build its Leesburg office; it was one of the prizes in the 2001 purchase of Farmers & Merchants of Winchester.

Rip Howard, Virginia market president for BB&T, says aggressive

Bank Bait?

Banks across America are waking up to realize that "retail appeal" has become vital in the increasingly competitive banking industry. Banks are now attracting customers by introducing new technologies and branch designs.

Tony Plath, a finance professor at the University of North Carolina at Charlotte explains that nationwide, banks realize that "their business is in retail also, with a slightly different product." In this case, the products banks offer are hooks, ways to get the customer to linger and buy something they ordinarily would not have. It is the banking equivalent to placing candy bars next to the checkout.

The hooks come in different forms. For many banks, it starts with atmosphere. Increasingly, bank lobbies are beginning to look like hotels, with long mahogany counters and couches inviting the customer to stay awhile. In fact, in Annapolis, Md., BB&T even converted a house into a branch, fostering a feeling of familiarity. Garnett Hamerman, a senior vice president at SunTrust, uses the bank's new Richmond, Va., branch as an example: "Everything is designed to appear more open and light." Gone are the closed-off cubicles and offices, with glass doors and open kiosks taking their place.

Some banks are also offering a winning combination of technology and marketing. For instance, last year Bank of America, which has pioneered many of these innovations, introduced the first "keychain credit card," offering all the features of a regular credit card, but at half the size of

a normal card. Not satisfied? No problem — ask your local Bank of America branch about its "Photo Expressions" program, a way of reliving your Kodak moments each time you swipe your credit card. Photo Expressions allows the customer to have any image of their choice printed onto their card, whether it is a pet or favorite vacation spot.

This advent of technology must also be engaging for the customer. As Hamerman explains, "We're trying to be hi-tech, but also hi-touch." This concept is at work in SunTrust's new drive-up system. Highly interactive, the customer in lanes not directly next to the window is now able to communicate with the teller via video.

Bank of America isn't the only bank employing retail tools. BB&T has a plus package that offers rewards to customers, such as coupons toward travel and entertainment. Since so many banks are employing these techniques, what ensures a successful program? Tony Plath suggests that the answer lies in offering "a pro-

motion a customer wants to buy. Some promotions are just bad. ... Rewards really encourage frequent use of a product."

What all these promotions and inviting atmosphere really boil down to is a good use of space. Banks must consider who they are trying to attract and where they are located.

One thing is clear: With the rapid advance of technology and a generation that has come to expect it, banks will continue to market themselves to new customers. It's a matter of survival.

— JULIA R. TAYLOR



Some bank interiors have developed a look more like hotel lobbies with an inviting "stay for a while" atmosphere.

branching works in Leesburg because it's the best way to lure the bank's bread-and-butter customers — individuals and small businesses. "Their choice of banking is the branches," Howard says. "They say they want branches, that's where they want to do their business. That's driven us to build branches."

You might think BB&T would be looking to thin its branching ranks in Loudoun, but Howard doesn't see it that way. He cites a recent survey that suggested small business clients visited their branches 4.5 times a week. "I honestly think there is a certain comfort level and feeling of security" that customers get in branches, Howard says. "I don't know if you totally get that feeling on the telephone or using online computers."

"At one time, it was thought branches would be dinosaurs. The only people who didn't believe that were the clients," Howard says.

A Branch Boom, But Not Here

While branch banking is booming in Leesburg, in other parts of the Fifth District things are quite different (see chart below). Despite the strong tie between branching and sales growth, banks for the most part in the Carolinas, Virginia, and Maryland were putting on the brakes in brick and mortar expansions. Only West

Virginia added to its banking network in the decade up to June 2004.

The lack of branching growth in most of the Fifth District is attributable to long-standing liberal banking laws in those states. North Carolina's first bank branch opened in 1804, and the competitive intrastate banking environment has produced a state that is second only to California in terms of branches per capita.

As a result, the Fifth District has developed into a banking powerhouse, analysts say. Charlotte is home to Bank of America and Wachovia, Nos. 3 and 4 nationally by assets, and No. 14 BB&T is based in Winston-Salem. Having learned how to survive in a free-for-all branching climate, North Carolina banks in particular were adept at cross-state branching as soon as it became legal to do so.

"There's no doubt that statewide branching made North Carolina banks very aggressive and very competitive," says Harry Davis, finance professor at Appalachian State University in Boone, N.C., and an economist for the North Carolina Bankers Association. "And another very important thing it did was create larger banks with layers of middle management." That meant that North Carolina could send its managers to locales like Texas to run their banks, but the opposite wasn't

happening because Texas was a unit-banking state, where branching was outlawed. "It was never a fair contest," Davis says.

The quirkiest trend was in Washington, D.C., which lost about 20 percent of its branches in the decade up to 2004. The FDIC's Phelps is unsure why this has happened, but says that one factor is probably consolidation, which caused banks to close redundant offices. Additionally, the FDIC found that economic factors have strong influence over a region's branching activity, and D.C. ranked last among U.S. states for average employment and population growth between 1994 and 2003. More generally, D.C. might reflect a trend of branch density falling in cities while rising in suburbs.

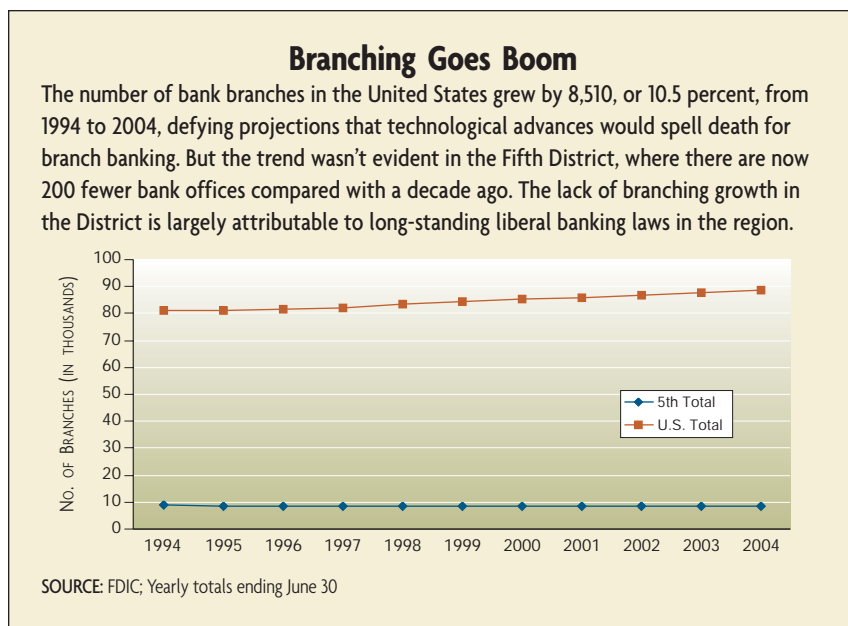
What's Next?

High-tech branches may have sex appeal, but they haven't proven themselves to be any more profitable, Meyer says. "We haven't found a lot of things to correlate [performance] with inside-the-branch décor or things of that nature," he says. More important are branch hours, visibility and the retail characteristics of the branch's neighborhood.

MarkeTech consultant Hal Hopson sees a lot of phone banks and Internet consoles growing cobwebs at bank branches. "The high-tech, whiz-bang stuff doesn't get a lot of use," he says.

None of this is to conclude that virtual banking offerings aren't taking hold. In 2004, an estimated 7.3 percent of banking transactions took place online, according to industry consultant TowerGroup. Next year, almost one out of every 10 transactions is expected to happen over the Internet. A recent *American Banker*/Gallup survey found that 30 percent of U.S. consumers now pay their bills online and most of those were very satisfied with their service.

Home mortgages are easily obtained over the phone and Internet, and firms not bound by bricks and mortar are discovering new ways to translate lower costs into landing

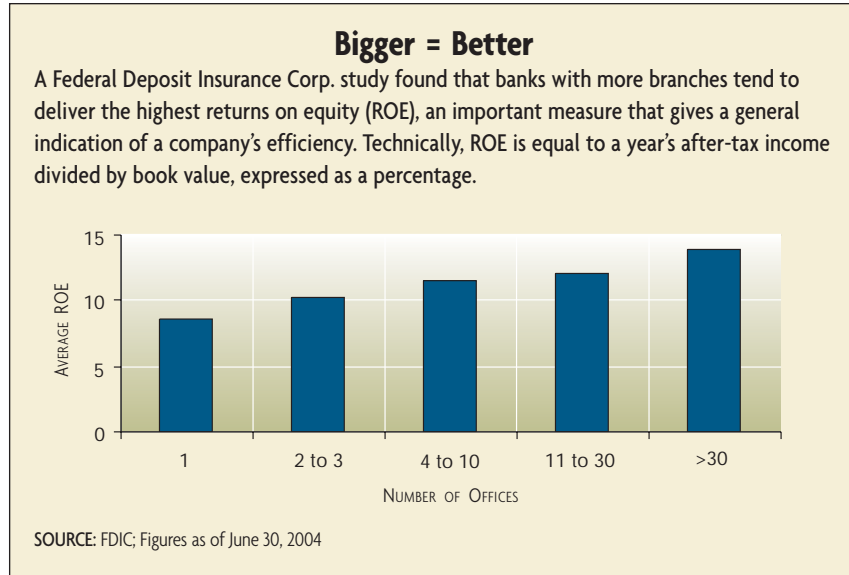


customers. Capital One Financial, the McLean, Va.-based credit card company, bills itself as “America’s largest online vehicle lender.” Its Web site can approve applications within minutes and deliver “blank checks” for buying cars by the next day. And since it doesn’t have to build and maintain costly branch offices, Capital One’s auto lending business can undercut interest rates offered by banks and credit unions.

Some financial institutions have proven you don’t need branches. NetBank, one of the first online-only financial services companies, is profitable and growing, with a strong mortgage banking business. At the same time, NetBank’s biggest drawback may be its lack of physical presence. Last fall, at least one investment bank lowered its stock rating for NetBank in part because so much of its business is derived from highly competitive wholesale and correspondent channels — not retail-oriented branches, like many of its rivals. Recognizing the power of bricks and mortar, E*Trade Financial Corp. — which started as an online stock-trading firm — has begun opening branches, most recently in Chicago. E*Trade’s branches do more than just court stock traders; they offer comprehensive financial services, including checking and lending.

We’re ending up with institutions that operate in both the real and the virtual world.

“Clearly as we go through time, more and more people will use



electronic banking and have less need for an on-site visit to a bank,” Davis says. “But right now, there’s still a very large percentage of bank customers who want to go talk to a person face-to-face. That percentage has surprised everyone by its size.”

Awad, the University of Virginia professor, says banks possess far more sophisticated technology than customers to date have shown a willingness to try. Part of that is simple aversion to change; part of it is a very real aversion to giving up personal information over online channels. Awad describes a standard pitfall for banks that offer loan applications on their Web sites. Many customers get to the point of downloading the form, but when it comes to keying in their Social Security numbers, they balk. “When they were asked for sensitive information, more and more

customers click away [from the site],” Awad says. “People are still sensitive about something that they consider personal.”

Now industry observers think the building spree is nearing its end. Having fleshed out their retail networks with bricks and mortar, banks in 2005 and beyond will start concentrating on training their customers to use more of the technology available at their branches. The future is expected to be full of offices that are staffed with fewer employees, making them more cost-effective. In an industry based on rules, regulations and standardization, branches in fact offer banks their best vehicles for customizing products and services to specific customers. “Branch banking is growing, but it’s with the idea of becoming as fully automated as possible,” Awad says. **RF**

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the conference *shuffle*

*The Atlantic Coast
Conference set off a
wave of league swaps.*

*Despite the outcry,
it shouldn't have
surprised anyone*

BY DOUG CAMPBELL

From Top to Bottom:

- 1) 2004 Atlantic Coast Conference Logo*
- 2) John Swofford, ACC Commissioner*
- 3) Miami vs. VA Tech, 12/4/04*
- 4) Duke vs. UNC, 2/5/04*
- 5) Jessica Trainor (Virginia) and Anne Morrell (North Carolina) at the 2004 ACC Women's Soccer Game*

In the fall of 2001 it was George Nemhauser's turn to serve as president of the Atlantic Coast Conference. Ordinarily this would be no big deal. The position of ACC president unceremoniously rotates each year among league faculty representatives. They tend to brand their terms with lackluster pet projects like sportsmanship or raising academic standards.

But Nemhauser, a professor at Georgia Tech's industrial and systems engineering department, had a gut feeling that the nine-school ACC was at a crossroads. So when ACC Commissioner John Swofford asked the question — "What's on your agenda?" — Nemhauser didn't hesitate: "We need to think about expansion."

And thus was set in motion the events that led to a seismic shift in athletic conference memberships across the National Collegiate Athletic Association (NCAA). By the fall of 2003, the ACC's historic and sometimes tumultuous march to expansion was complete. Ultimately accepting invitations to join the ACC were three schools: University of Miami, Virginia Tech, and Boston College. The three jumped from the Big East, setting off a nationwide chain reaction of conference swaps. In all, 19 schools switched leagues during the second half of 2003, and some analysts believe more shuffling is to come.

In the aftermath, ACC leaders were giddy. "We have landed at a superb

PHOTOGRAPHY: TOP TWO IMAGES COURTESY OF ACC; BOTTOM THREE IMAGES BY JEFF CAMARATI/GETTY IMAGES

place,” Swofford said during a June 2003 press conference to announce the first phase of expansion. In short order, the ACC had enhanced its revenue-generating prowess in football while at the same time preserving its reputation as the premier men’s basketball conference. Television contracts were quickly renegotiated to reflect the addition of the Boston and Miami markets, Nos. 6 and 17, respectively in the nation, adding millions of dollars to the ACC’s take. This fall the ACC will hold its first-ever football championship, worth an estimated \$7 million. And it stands a far stronger chance of placing two schools in the coveted Bowl Championship Series (BCS), whose title game is worth as much as \$14 million and lesser matchups not far behind.

Meanwhile, the Big East was in crisis, reeling from what Commissioner Mike Tranghese had called “the most disastrous blow to intercollegiate athletics in my lifetime.” In the space of a few months the Big East became the Medium East, having lost three of its highest-profile schools. Suddenly, it was scrambling to survive with only six teams playing football.

The media portrayed the story in multiple ways. Some said it was a case of brilliant strategy by the ACC contrasted by the flat-footedness of the Big East. Others saw it as an example of greed overtaking amateur sports.

Neither turned out to be a fair characterization. Interviews with economists and NCAA observers suggest that conference realignment was going to happen, whether or not the ACC led the charge. Powerful market forces were at work, creating incentives for athletic leagues to grow membership.

What’s more, the Big East was hardly asleep at the wheel. Big East leaders in the late 1990s and in May 2003 approached the ACC about merging their football leagues. On both occasions it was the ACC that said ‘no,’ in the end deciding to cherry-pick some of the Big East’s marquee schools without having to take on the risks of operating the proposed 18-team league.

In hindsight, it all makes perfect sense. The ACC’s and the Big East’s

actions are in keeping with microeconomic models of how competitive industries work.

“You can’t hold back these market forces,” says Raymond Sauer, an economist at ACC member Clemson University and keeper of the Web-log www.sportseconomist.com.

Why It Happened

Pop quiz: The ACC is expanding from nine member schools to 12 because:

a) Miami couldn’t fathom hosting a home football game against lightweight Big East foe Rutgers.

b) Newly struck television contracts will bring the ACC an estimated extra \$16 million each year.

c) ACC leaders feared that Florida State would leave if Miami was gobbled up by the Southeast Conference (SEC).

Answer: All of the above.

At one time, all the ACC’s schools called the Fifth District home. Established in 1953 with eight schools, the Greensboro-based ACC lost charter-member University of South Carolina in 1971 to the SEC but added Georgia Tech in 1978 and Florida State in 1991. In Georgia Tech, the ACC laid claim to the valuable Atlanta TV market; in Florida State, it finally claimed a top-tier football team.

The 1990s and beyond have been good years to the ACC. Basketball powerhouses Duke University, University of North Carolina, and University of Maryland won championships, earning the league a deserved distinction as the best in hoops. And Florida State took home the No. 1 football ranking for the 1999 season.

Nemhauser’s hunch — shared by observers across the country — was that time was running short for conferences to shore up membership and protect their goodies. But if it were to go through with enlargement, the ACC would be making a huge bet. The league annually pays out about \$9 million to \$10 million each to its member schools, according to tax filings. Adding three more would mean having to come up with an additional \$30 million in annual revenue to make sure incumbents weren’t giving up anything.

The ACC hired sports-business consultant Dean Bonham to conduct an analysis of expansion’s pros and cons. Bonham’s answer, contained in a report that was a year in the making, was a robust recommendation for adding three schools. In Bonham’s analysis, short-term monetary gains were secondary to the pressing task of durability.

“The bottom line came down not to money but survival,” Bonham says. “The ground underneath the collegiate world was moving at a pretty rapid rate. We foresaw there was going to be a lot of alignment and realignment. If the ACC didn’t expand, some of their competitors or other conferences would.”

The collegiate map that Bonham and ACC managers analyzed in 2002 laid bare the need for action. Out of 11 Division I-A conferences, the ACC ranked fifth in total revenue-per-school, according to an NCAA study (see table on page 22). On an average, per-school basis, the league was losing money, albeit just a bit. Additionally, the ACC relied heavily on men’s basketball for revenues, which would have been fine except that football generally pays a lot more. The bigger conferences, especially the SEC and the Big 12, gained much more from their football programs. While the ACC took in an average \$8.1 million per school for men’s basketball and \$11.8 million for football, the SEC generated \$5.7 million from men’s basketball and a whopping \$26.9 million from football.

Where does all that cash come from? TV and radio revenues from contracts negotiated by the schools themselves account for 7 percent of Division I-A athletic program support. Another 9 percent is from NCAA and conference distributions. Most of that money — an estimated 90 percent — comes from broadcast agreements negotiated by the NCAA and the athletic conferences, such as the \$6 billion, 11-year pact allowing CBS to broadcast the NCAA basketball tournament. But the bulk of collegiate athletic funds derive from ticket sales — 26 percent. Schools with 80,000- to 100,000-seat football stadiums, packed seven times

a year, reap even larger shares from ticket sales. Larger still are alumni and booster contributions at 18 percent and direct institutional support at 10 percent.

Tipping the scales in favor of conference enlargement was a relatively new post-season feature of the NCAA — the Bowl Championship Series.

The BCS was set up in 1998 for the purpose of declaring a bona fide national championship in football. At the same time, it preserved the traditional, and itself highly profitable, bowl game system. Six Division I-A conferences are guaranteed bids to the four BCS games — the Orange, Rose, Sugar, and Fiesta bowls — with the top two ranked teams in the country squaring off for the so-called national title. (A fifth BCS bowl game may be added soon.) The ACC is one of those with guaranteed bids. The payoff for a national title entry is up to \$14 million. Even the lesser bowls are worth as much as \$11 million.

The conferences that get automatic berths are known as BCS members, and membership has its privileges. Non-BCS conferences get a cut of the bowl game spoils, but it amounts to between \$300,000 and \$800,000, or as little as \$74,000 per school. By comparison, BCS conference schools take in about \$2 million each in bowl game payouts. That means in any given year, Wake Forest University can expect a big BCS payout even though it historically hasn't sent a single team to a BCS game.

For the ACC, it was financially imperative to keep a seat at the table at the lucrative BCS. On average in 2002, conference schools were losing money on their athletic programs. That's in part because athletic revenues must be spread around to fund a typical school's less visible sports, ranging from soccer to field hockey. But those at the top of the food chain — schools in the biggest conferences, all in the

Conference Shuffle

Since the summer of 2003, 19 schools have announced changes in conference affiliations. The ACC's plucking of three Big East schools got the ball rolling.

To the ACC (all from Big East)

Miami
Virginia Tech
Boston College

To the Atlantic 10 (both from C-USA)

UNC-Charlotte
Saint Louis

To the WAC (all from Sun Belt)

New Mexico State
Utah State
Idaho

SOURCE: NCAA; Conferences

To the Big East (all from C-USA)

Cincinnati
Louisville
Marquette
DePaul
South Florida

To Conference USA

Rice (from WAC)
Southern Methodist (from WAC)
Tulsa (from WAC)
Marshall (from MAC)
Central Florida (from MAC)
Texas-El Paso (from WAC)

moting stability, only seldom reaching out to swipe each other's schools.

University of Chicago economist Allen Sanderson likens collegiate athletic conferences to a cartel. When everybody obeys the unwritten rules, everybody profits. "But there's always the incentive to cheat, whether it's OPEC or the NCAA," Sanderson says.

The ACC wasn't cheating, but it was moved to take action after observing several eyebrow-raising developments. One risk that several ACC managers cited was that Miami — crowned football National Champion in 2001 — would join the SEC if not courted by the ACC. In their worst nightmares, ACC officers saw Florida State deciding to follow, thus depleting the conference of its

foremost football draw. At the same time, the opportunity to widen its TV audience from New England down to the southern tip of Florida was too good to pass up. They wouldn't even have to change the conference's "Atlantic" name.

Thus, the key to making money in college athletics is strongly tied to conference membership. With the introduction of the BCS, schools had a new incentive to consider changing allegiances.

Dan Fulks, an accounting professor at Transylvania University in Kentucky and an NCAA consultant, recalls a conversation with a BCS commissioner about the widening gap between "have" and "have-not" conferences. The commissioner replied, "Look, don't blame me. My job as commissioner is to make as much money as I can for the schools in my conference, and that's what I'm going to do."

Conference Rivalries Heat Up

To be sure, conference realignments are nothing new (see sidebar). The reason they happen relatively infrequently has to do with the "industry" structure. Think of athletic conferences as rivals in an industry where the schools are the suppliers and fans and the TV broadcasters are the buyers. The conferences are mainly differentiated by their school membership. They maximize their profits by pro-

foremost football draw. At the same time, the opportunity to widen its TV audience from New England down to the southern tip of Florida was too good to pass up. They wouldn't even have to change the conference's "Atlantic" name.

"It was our belief that a number of changes would be coming anyway," ACC Commissioner Swofford says. "If we were proactive, then we were in a much better position to effect change that would impact us positively rather than having to react."

Acquiring schools from the Big East wasn't the ACC's only option, however. After the BCS system was announced, Big East leaders laid out their strategic options. They realized that being No. 6 in revenue in an 11-conference system was a precarious position.

In 1997 and 1999, the Big East approached the ACC about joining the two leagues' football programs into a single "federated football conference," according to parties familiar with the talks. The thinking was that such a coalition would upgrade the conferences' negotiating position with TV networks. Together, the Big East and the ACC would command an 18-team

football league that could deliver the entire East Coast broadcast market.

But the ACC was cool to the idea in the 1990s. And when Big East managers pitched the idea anew in the summer of 2003 in an effort to fend off the ACC's expansion, the answer again was 'no.' Neither Swofford nor Big East officials would comment about the ACC-Big East merger talks. Analysts interviewed for this story said the ACC was probably turned off by a merger for several reasons, including an unwillingness to adopt separate football and basketball memberships and the logistical concerns of operating an unwieldy 18-school league.

"The Big East is a cobbled together conference in the first place, and their next move is trying to cobble the ACC into their mix," says Sauer, the Clemson economist. "It makes good strategic sense for them to do that but they're not really taking the ACC up a peg with that proposal. It was [the

ACC's] opportunity to choose between alternatives and they clearly chose one that made them better off."

The ACC's Competitive Advantage

How come the ACC was in position to make such a choice? A crucial advantage the ACC held over the Big East was organization. The ACC has nine member schools that participate in all sports and distribute conference revenues equally.

By contrast, the Big East, based in Providence, R.I., created its basketball and football programs separately. It kept nine schools for football purposes only and 14 for basketball. Georgetown University, for example, participates in Big East basketball but doesn't field a Division 1-A football team. West Virginia University, however, plays both. Conference revenues were not handed out equally, and Big East members didn't give Commissioner Tranchese the same leeway that

ACC schools did Swofford.

"The way it was structured, it didn't allow the commissioner to go out and get things done," Sauer says. "It's not that John Swofford was any more capable than Tranchese up in the Big East. It's just that his organization enabled Swofford to effectively move in the direction that the economic forces dictated the football conference would move."

If there's a downside to expansion, it's the deterioration of some longtime rivalries. Every fan wants Duke to come to his school at least once a year for hoops, but that's no guarantee under an expanded league. Swofford, who played football at North Carolina before rising to the league's commissioner office, says he understands the importance of fan sentiments in the ACC's culture and revenue stream. At the same time, "The feeling was that the collective gain far outweighs the things we would give up."

Conference Came Undone

Conferences do collapse. Rewind to 1996 for the final incarnation of the once-proud Southwest Conference (SWC). An 82-year-old league, marquee members included the University of Texas, Texas A&M, and Baylor University. Adorning member trophy cases were seven national football championships, five Heisman Trophies, and two women's basketball titles.

But talk about regional: After the University of Arkansas left in 1992 for the Southeastern Conference, all eight members were from Texas. That was fine when cross-state rivalries provided all the revenue a conference needed to thrive, but it was a huge liability at the dawn of the 1990s when national TV contracts became the norm.

Texas is big, but it could deliver only 7 percent of the nation's TV markets. Nearing its deathbed, the SWC talked with the then-Big Eight about a merger. Instead, four SWC schools — Texas, Texas A&M, Texas Tech, and Baylor — simply up and left for the soon-to-be

Big 12. The Western Athletic Conference (WAC) swallowed three of the remaining schools, Southern Methodist University, Rice University, and Texas Christian University, while the University of Houston hopped to the newly founded Conference USA.

The mid- and late-1990s, then, saw nearly as much conference shuffling as in 2003, bolstering the NCAA's assertion that conferences have long been "adding new members, casting off those that no longer fit and changing their geographic landscapes." Witness the near-unraveling of the WAC in 1999, when eight schools, including four charter members, withdrew to found the Mountain West Conference.

The WAC soon picked up Boise State University and Louisiana Tech University, giving it 11 members — until former SWC member Texas Christian switched conferences again, leaving for Conference USA at the end of the 2000-2001 season. Idaho, New Mexico State, and Utah State have agreed to join the WAC in 2005. But, at the same time, the conference

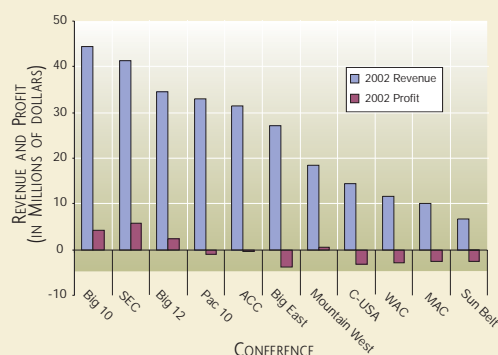
will lose Rice, Southern Methodist, the University of Texas at El Paso, and the University of Tulsa.

After all that, has the conference shuffling reached its limit? "I believe that conference realignment will occur when it is economically feasible to do so," says Patrick Rishe, an economist at Webster University in St. Louis. But even Rishe believes it will be a while before more conferences fold, expand, or otherwise realign in significant fashion.

"I think that we've just about stretched our limits. Perhaps the Big 10 [which, despite its name, actually has 11 members since Penn State joined in 1993] will add another team soon to reach the magical number of '12' that's necessary for a football championship. And perhaps the Pac 10 will do the same soon," Rishe says. "When the Pac 10 does this, it will cause a mini-domino effect as the lesser West Coast conferences scramble to try to replace teams that shift to other conferences, but nothing like what we recently saw." —DOUG CAMPBELL

Athletic Conference Cash

In 2002 the ACC was the fifth-largest NCAA conference by revenues.



NOTE: Figures are per-school averages.
SOURCE: NCAA

The Payoff

After some stumbles and lawsuits, in which at first only Miami and Virginia Tech were asked to join, the ACC completed its growth spurt in October 2003 when Boston College signed up. With B.C. on board, the ACC had achieved the magic number 12, qualifying under NCAA rules to hold a conference football championship game.

The collective gain was almost instant. TV contracts were quickly renegotiated, and even incumbent ACC schools are to take in an estimated \$800,000 more annually under newly inked deals with ABC and ESPN. Also, new contracts were struck with Charlotte-based Jefferson Pilot Sports (JP Sports), which has top distribution and broadcast rights to ACC basketball and regional rights to ACC football. (JP Sports also has rights to SEC regional football games.) Jimmy Rayburn, vice president of operations with JP Sports, thinks the loss of round-robin-style matchups in basketball will hurt but agrees with Swofford's overarching view that the conference improved itself.

"It's not a perfect world. But did they improve themselves? Yes. They did in terms of financially improving themselves and in terms of having a seat at the table in the future of any big football talks, whether that's playoffs or an expanded BCS," Rayburn says.

The Big East wasted little time once all the ACC pieces fell into place. By November 2003, it had picked up five new schools to replace the three departed. But in the process, the conference pegged its future on basketball and, according to some observers, may lose its automatic bid to the economically rewarding BCS. The five new schools are Cincinnati, Louisville, DePaul, Marquette, and the University of South Florida. Only the first two of those schools have Division 1-A football teams, and neither is a perennial standout. When all the league switching is done, the Big East will have eight "full" members that play both football and basketball and another eight that play just basketball.

Strategically, it may have been the Big East's best, and only, option. "The Big East, realizing its status in football took a hit; they had to ask themselves a question," says Patrick Rishe, an economist at Webster University in St. Louis. "Based on the landscape in the short-term all we can do is stay floating. So why not go ahead and become the strongest basketball conference?"

John Marinatto, a Big East associate commissioner who was closely involved in the expansion process, says the new members accomplished the conference's goal of growing TV revenues. He describes Cincinnati and Louisville as significant broadcast markets for football. Noting that the past two basketball championships have been won by member schools

Syracuse and Connecticut, he argues that the Big East is now even more so "the strongest basketball conference in the country." As for the Big East's participation in the BCS, Marinatto believes the league's spot is secure for "the foreseeable future."

What's Next?

The view from the ACC today is especially bright. The league placed six teams in bowl games, but only mustered one — new addition Virginia Tech — in the BCS. ACC men's basketball retains its pre-expansion cache, with national broadcasts of pairings a commonplace. Between the new television contracts, the possibility of an extra BCS game and a football championship, the ACC already has topped the necessary \$120 million annually to provide all its schools more money than before expansion.

"I think the ACC is done (expanding) for the time being, but it's not clear to me what the national scene will look like," says Prof. Nemhauser, who started it all.

Conference realignment is a game with no clock. The BCS came under fire — again — this year for failing to produce an undisputed national champion, as undefeated Auburn was left out of the title game. Additionally, there was evidence that the Big East's recent departures have already weakened the conference to the point where it should no longer get an automatic BCS bid: Big East champion University of Pittsburgh went to the Fiesta Bowl despite its middling 8-3 record. Whether the BCS expands or shrinks membership, whether broadcasters recalibrate how much they're willing to pay for airing rights — these will be the main factors in determining if the conference earthquake of 2003 has run out of aftershocks. **RF**

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sink OR SWIM

Fifth District coastal ports must continue to expand to remain competitive

BY CHARLES GERENA

A few autumns ago, a single barge sailed the Intracoastal Waterway along the Carolina shore. Sitting atop the vessel, like massive stallions of metal and rivets, were two cranes that traveled more than 160 miles from Charleston, S.C., to Wilmington, N.C.

This voyage signaled progress for both ports. After making their grand entrance in Wilmington in October 2003, the cranes helped boost the capacity of the city's port. One of the beasts, a gantry crane that can carry up to 150 tons, replaced a 25-ton crane that had been in service for almost half a century. For Charleston's port, the sale of the older cranes was part of an effort to handle more cargo from bigger ships.

New York, California, Texas, and

Louisiana have the busiest ports, but the Fifth District is no slouch with four major coastal facilities. Three of them — the Port of Charleston, the Port of Baltimore, and the Port of Virginia in the Hampton Roads region — were among the nation's 30 busiest in 2002, the latest year available for aggregate data. Looking at foreign trade alone, these ports currently rank in the top 10 in terms of dollar value of goods, and the top 25 in metric tons moved and container volume. The Port of Wilmington is among the 25 busiest container facilities.

A state chartered, functionally independent authority controls the land and facilities at each port. Charleston's and Wilmington's maritime facilities must be financially self-sufficient, though they occasionally

receive government funding for capital projects. The Port of Baltimore and the Port of Virginia receive regular appropriations as part of their states' transportation departments.

In sum, these semi-private enterprises play a pivotal role in global commerce. Without them, retailers couldn't sell merchandise from all over the world at the low prices that consumers demand. Think of how public airports enable the airline industry to function by providing the shared infrastructure that carriers couldn't afford to own and operate individually.

At one time the physical limitations of ports dictated the size of cargo ships. Today, the relationship is reversed. Shippers push for bigger vessels to realize economies of scale and to cut costs for customers. As a result,

PHOTOGRAPHY: BILL MCALLISTER

public ports have boosted their capacity and capability to remain competitive. From 1998 to 2002, they devoted nearly \$7 billion to capital improvements, or about one-quarter of total investments made over the last 75 years.

At some ports, maritime trade is changing faster than they can adapt. In the Fifth District, ports have been adding cranes, deepening and widening waterways, and investing in other improvements to keep pace. The Port of Virginia and the Port of Charleston appear to be in the best competitive position to accommodate the biggest vessels, while the Port of Wilmington has the advantage over its larger East Coast competitors in terms of excess capacity.

But the future holds additional challenges for Fifth District ports to expand and adapt. Those that cannot

overcome constraints on waterway capacity, road and rail infrastructure issues, or land availability problems due to waterfront redevelopment, will be out of luck. “If you aren’t able to meet the needs of the shipping community, you run the risk of ships being attracted to another port,” says Kathleen Broadwater, deputy executive director at the Maryland Port Administration, which operates Baltimore’s port.

In the competitive world of global trade, such shifts in cargo flow are routine. For individual ports, however, lost business could translate into decreased economic activity on the local and regional level. Fewer people are involved in water transportation of freight — 37,400 in 2002 versus 47,400 in 1992 — but they make a comparatively good living. For example, a stevedore who loads and unloads ships earns an estimated \$16.95 an hour compared to \$15.03 for the average blue-collar worker. The businesses drawn to a port, from fuel suppliers to distribution centers, generate additional employment and spending.

Bigger, Faster, Better

It takes a small army of stevedores, crane operators, and other unionized workers to run a maritime facility — Baltimore’s port-related employment approaches 16,000 people. Historically, these workers have loaded bundles of cargo from ships, separated them into smaller shipments, and loaded them by hand and forklift into trucks and trains.

“There is a lot of inefficiency because of the restrictions on what tasks they can perform. They also earn higher wages,” says Wayne Talley, an economist at Old Dominion University who heads the school’s International Maritime, Ports, and Logistics Management Institute.

In order to minimize labor costs, shippers have moved from break-bulk to container shipping since the 1960s, transforming a labor-intensive endeavor into a more capital-intensive activity. Enormous cranes now scoop up standardized boxes stuffed with

goods and transfer them from ship to land with ease and efficiency.

According to Talley, cargo that used to take a week to unload can be moved in less than 24 hours if it’s stored in containers, resulting in substantial reductions in inventories. Container shipping also has resulted in less theft, since boxes are sealed until they arrive at a consignee, and less damage to cargo in transit.

As competition in global trade has intensified, container shippers have strived to transport more boxes per voyage and, thus, decrease per-unit transportation costs. This has meant employing vessels that are longer, wider, and deeper than ever before.

The largest ships, called “post-Panamax” since they exceed the dimensions of the Panama Canal locks, typically measure 1,100 feet in length and 136 feet in width, draw a maximum of 46 feet of water, and hold 5,000 to 8,000 TEUs. (ATEU, or “20-foot equivalent unit,” is equal to one container measuring 20 feet long, 8 feet wide, and 8 feet deep.) That’s a big difference from the earliest container ships that carried less than 1,000 TEUs. At the same time, other shippers have demanded bigger vessels to transport other types of cargo, from supertankers that carry enough oil to power a small city to bulk carriers that transport tons of grain, coal, and other materials.

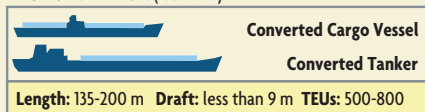
Talley offers one example of how ports have reconfigured themselves to service these vessels. A ship used to dock at a terminal perpendicular to a finger pier. Many ports have knocked down those piers so that container ships can dock parallel to a terminal and be offloaded by cranes.

Ports also have enlarged their waterways, built longer docks, and purchased taller cranes. For example, the Port of Virginia is adding eight new cranes to its main terminal in Norfolk that stand higher and reach out farther into the water than any other crane, enabling the terminal to service the next generation of container ships. More than \$45 million was spent on the cranes and millions more

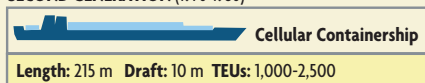
Five Generations of Containerships

The capacity of containerships has increased tenfold in the last 50 years, driven by demands of shippers to minimize per-unit transportation costs. Ports have been forced to keep up.

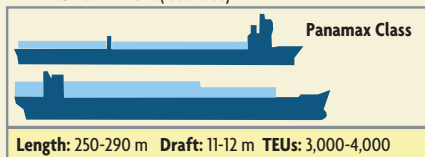
FIRST GENERATION (1956-1970)



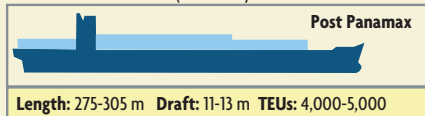
SECOND GENERATION (1970-1980)



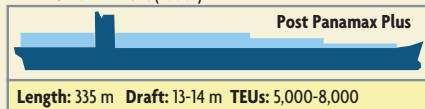
THIRD GENERATION (1980-1988)



FOURTH GENERATION (1988-2000)



FIFTH GENERATION (2000+)



SOURCE: Jean-Paul Rodrigue, et al. Transport Geography on the Web. Hofstra University, Department of Economics & Geography, 2004

to strengthen wharves to support the cranes.

While size matters, ports have had to work smarter too. For instance, the Port of Charleston has been implementing a yard management system that allows for more accurate tracking of containers. These and other operational upgrades have enabled the port to handle a near doubling of its cargo volume in the last 10 years without developing any new terminals.

With global trade accelerating in recent years, port officials anticipate further growth in the movement of containerized cargo, as well as break-bulk shipments, bulk commodities, and other goods. Much of this growth is expected to continue coming from trade with Asian countries, especially imports.

Officials in the Fifth District think their facilities will continue to attract a significant share of global cargo flow. Economic trends support their optimism. For one thing, distribution facilities are opening closer to population centers on the East Coast, many of which are near ports.

"Within the last five years, Virginia has attracted a significant number of major distribution centers," says J. Robert Bray, executive director of the Virginia Port Authority. These centers, opened by mass retailers like Home Depot, Target, Wal-Mart and Family Dollar, import large amounts of merchandise, so they have "demanded increased shipping service [and] caused ships to offload much more cargo than they did in the past."

At the same time, there has been mounting interest in East Coast ports as congestion at their West Coast counterparts has led to higher costs and headaches for shippers sending goods to and from Asia. Last October, dozens of ships reportedly waited at the Port of Long Beach to dock and unload consumer products bound for retailers stocking up for the 2004 holiday season. On top of that, the price of cross-country rail and truck transportation has been rising, adding to the expense of mov-

ing goods from the West to Eastern and Midwestern markets.

The last straw was a labor dispute that eventually shut down 29 West Coast ports in the fall of 2002. Asian shippers and producers had to reevaluate their distribution routes to keep their freight flowing. In the process, they found a viable alternative. Instead of sailing directly across the Pacific Ocean to West Coast ports, smaller ships could go around North America via the Panama Canal to reach East Coast ports. "Once shippers began that process, producers rearranged their just-in-time inventory to accommodate the additional time that the cargo spent on water," Bray says.

In the future, it may be more common for larger post-Panamax ships to bypass the West Coast and take the long way around to the East Coast, primarily by going through the Middle East via the Suez Canal and then crossing the Atlantic Ocean. However, this will happen only if it also proves to be economically viable for shippers.

The East Coast has some excess port capacity to handle any redirected cargo volume, according to Hofstra University geographer Jean-Paul Rodrigue. Most of the slack is at smaller facilities like the Port of Wilmington.

"We are seeing a tremendous amount of congestion starting to occur at competing ports north and south of us," says Thomas Eagar, CEO of the North Carolina State Ports Authority. "That's bad news for them, but good news for us. We are in the midst of serious discussions with two or three major container lines looking to divert [cargo] or bring new services to the Port of Wilmington."

Reality Check

But how much additional cargo volume can Fifth District ports realistically capture in the near term? Even if more shippers utilize the wider and deeper Suez Canal and other longer routes to the East Coast, many of their vessels wouldn't be able to fit into most ports once they arrive. At present, the Port of Virginia is the

only Fifth District facility that's big enough for the biggest ships of the present and the future.

Additionally, container ships stop in fewer places. "They want a port which can unload their containers very quickly. Today's ship spends most of its time moving; in the past, a ship spent most of its time in port," says Rodrigue. This could mean more business for larger ports, while the smaller ones will become merely feeders.

Ports could specialize in handling non-containerized goods. For example, Baltimore has become the largest hub for "roll-on/roll-off cargo" such as automobiles and farming equipment, and the vessels that carry them aren't as big as container ships. Nevertheless, every Fifth District port will want to grab its share of container shipping since it accounts for 90 percent of the value of non-bulk goods transported globally. That will require an acceleration of capital investments.

First, there is the task of deepening and widening waterways even further. Since channels are federal property, the Army Corps of Engineers performs routine dredging that clears channels of silt and other debris, while federal funding covers part of the cost of enlarging channels. Ports pay the remainder of that tab, plus they are responsible for deepening the access channels that lead to individual terminals and the berths where ships dock.

Some ports in the Fifth District are further along than other facilities. The Port of Virginia and the Port of Baltimore currently have 50-foot-deep main channels, while the Port of Charleston has an entrance channel measuring 47 feet deep and an inner harbor of 45 feet following the completion of a \$150 million deepening project in 2004. The Port of Wilmington also finished dredging its navigation channel to 42 feet last year.

So what if the Charleston port's channels are shallower than Virginia or Baltimore? "It makes a heck of a difference," says Bray of the Virginia Port Authority. "Some of the larger ships that Maersk and other shippers

have will draw a little more than 47 feet of water when fully loaded.” Channels need to be at least 50 feet deep to provide a margin for error when water levels in harbors change.

For now, the Virginia and Baltimore ports are ahead on this count. The Charleston port’s harbor could be deepened, but officials are holding off on doing it due to the cost, according to spokesman Byron Miller of the South Carolina State Ports Authority. Any dredging that goes beyond 45 feet lowers the federal share of project funding to 50 percent. Instead, the port will continue investing in its existing terminals and build a new span across its main shipping channel to accommodate taller ships.

Perhaps Charleston shouldn’t trouble itself. Having deep channels doesn’t do much good if a port’s

berths are shallower. The Port of Virginia’s Norfolk terminal has 50-foot berths, but the Portsmouth and Newport News terminals have berths that are only 45 feet deep and 42 feet deep, respectively. Bray says there isn’t a need to excavate at these terminals, but another deepwater facility is planned across from the Norfolk terminal at Craney Island, an area created with dredge material.

At the Port of Baltimore, an estimated 40 percent of its berths are too shallow. Some of them are being deepened, says Kathleen Broadwater at the Maryland Port Administration, but others will have to wait until the port’s older terminals are rebuilt so that dredging to 50 feet doesn’t undermine any structures. Such rebuilding projects are pending funding from the state legislature. Meanwhile, the Port of

Charleston recently dredged all of the berths at one terminal to 45 feet and three berths at its main Columbus Street terminal to 52 feet, putting it ahead of its Fifth District competitors.

In addition to making more room in its waterways for container ships and other large vessels, ports will need more dry land as operational improvements at existing terminals prove insufficient to deal with rising cargo volume. Land also has to be available nearby for additional warehousing and distribution centers.

Some ports have land inventoried for future expansion, but it can take a while to develop it. The construction of a new terminal for the Port of Charleston at a former naval base will take up to five years once the permit is approved.

Moreover, the land may never be fully exploited if there are insufficient

Cruisers and Containers

Containers aren’t the only things that Fifth District ports handle. Cruise ship passengers have joined the flow of goods at terminals in Baltimore, Norfolk, and Charleston in the last few years, generating new business and tourism-related dollars that have prompted some cities to make additional investments in their cruise facilities.

Traditionally, south Florida and New York have been the most popular departure points for cruisers. In 2003, their ports handled about 5.1 million of the 7.1 million passengers who set sail from the United States. But several factors have created opportunities for other ports to attract some of this passenger flow.

According to Brian Major, spokesman for the Cruise Lines International Association, more ships are sailing — the worldwide fleet has grown by two-thirds in the last five years alone — and cruise operators are looking for more options to offer to repeat customers. Both trends have fueled the need for additional departure points.

At the same time, cruise operators have moved their home-ports closer to coastal cities, explains Major. “With the reluctance to travel far away and to fly, [they believed] people would appreciate having a ship close to a large, regional population center that is within driving distance.”

Finally, cruise operators have more flexibility in where they choose to operate. Ships are much faster, enabling them to embark from ports farther away from their destination and make additional stops during their journeys without losing time.

Fifth District ports have managed to attract their share of cruise ship calls. In 2003, 31 ships departed from Baltimore, another 31 from Norfolk, and 17 from Charleston, and all three ports experienced growth in departures for 2004. No cruise

ships leave from the Port of Wilmington regularly, but they do stop there occasionally as they travel along the East Coast.

This volume is relatively small compared to the hundreds of cargo ships that call at ports every day, but they are still a significant source of revenue. “Port service providers at each of the embarkation ports and ports-of-call in the United States provide a broad range of services, including tugboat and piloting services, stevedores, passenger reception services, warehousing and other material handling services,” noted an August 2004 economic impact study commissioned by the International Council of Cruise Lines (ICCL). “During 2003, the cruise industry spent \$1.6 billion on such port services.”

Additionally, the passengers and crew on cruise ships spend their money in nearby communities. The ICCL study found that about a third of cruisers stay one or more nights at a port city and spend an average of \$195 per visit. Those who arrive the day of the cruise dole out an average of \$17 per visit while ship personnel spend \$29 per visit. (As a side note, the big-spending overnight passengers are smaller in number: 2.3 million compared to 4.8 million day-of-arrival passengers and 4.4 million crew members.)

Going forward, waterway capacity for cruise ships shouldn’t be a problem. Most ports can handle the largest vessels. However, terminal capacity could be an issue if Fifth District ports continue attracting the attention of cruise operators. So, city officials in Norfolk plan to build a new \$36 million cruise ship terminal to replace a temporary facility next to the Nauticus science center, while Maryland will invest \$3 million to \$4 million to renovate a cargo terminal in Baltimore to exclusively serve cruise lines. Charleston already has a cruise ship terminal in its downtown historic district.

— CHARLES GERENA

roads and rail lines to transport the additional cargo volume. Charleston's proposed expansion on Daniel Island was scratched partly due to concerns about nearby road capacity, while a proposed third bridge-tunnel system in Hampton Roads is critically important for the Port of Virginia's future terminal on Craney Island because it will help relieve local traffic jams.

"More and more folks want to live closer to the water," says Miller. "That's putting additional pressure on road infrastructure. As the [coastal] population continues to grow, perhaps even faster than the trade grows in port cities," governments will have to respond.

Cargo Or Condos?

Coastal development has also made it difficult for ports to expand. "Most of our major commercial ports are located in highly developed, urban areas, and as a result face real constraints on how much land is available for use as marine terminals," said Christopher Koch, president of the World Shipping Council, in May 2001 testimony to a House of Representatives subcommittee.

Homes and businesses surround the terminals of the Port of Virginia, but there is still some room for projects such as the planned expansion of a paper distribution facility near the Newport News terminal. Development is occurring along Wilmington's waterfront, but mostly in the northern half where older maritime facilities are being converted into condominiums, offices, and marinas. The southern waterfront where the port resides has remained mostly commercial. As for Baltimore and Charleston, residential, office, and tourism-driven retail development encroach on maritime activities, making port expansion very difficult.

Every Fifth District port competes for land with the private sector to some degree. Waterfronts contain underutilized or abandoned industrial property, but they also offer great views that residents and office workers value. "The most desirable land is always coastland, so [ports] have a lot of competition with real estate development," Rodrigue says. "People prefer to see condos rather than a port terminal."

Port authorities have the power of eminent domain, thanks to state legislation, but they rarely use it. Taking private property for public use usually requires lengthy court proceedings that often become mired in legal disputes. Additionally, this power isn't unlimited.

Rather than public ports bidding against private developers, some port advocates suggest using restrictive zoning to preserve waterfront property for future port expansions. In September, Baltimore officials created a "maritime industrial overlay district" that prohibits nonmaritime development along a large stretch of harbor for the next 10 years.

But what if ports don't need the land and other industrial users aren't demanding it due to consolidations and market shifts in the manufacturing sector? The rezoned property would simply sit unused.

Such a scenario would probably be hard for local governments to swallow. Since their interest is in encouraging economic growth, they provide incentives like tax breaks and clean-up assistance to support waterfront redevelopment. "I have heard of horror stories where real estate projects aimed at closing almost the entire port because building condos and commercial real estate would gener-

Where Ports Stand

U.S. Waterborne Foreign Trade, Total

(Thou. of Metric Tons)

Port	2003	Rank Among Top 25
Baltimore	22,443	18
Norfolk	22,011	19
Charleston	17,245	22

U.S. Waterborne Foreign Trade, Total

(Mil. of Dollars)

Port	2003	Rank Among Top 25
Charleston	39,375	5
Norfolk*	29,486	6
Baltimore	25,956	8

U.S. Waterborne Foreign Trade, Containerized

Cargo

(Thou. of TEUs)

Port	2003	Rank Among Top 25
Charleston	1,250	4
Norfolk*	1,093	6
Baltimore	307	13
Wilmington	72	25

NOTE: *Excludes trade at Newport News and Portsmouth terminals at the Port of Virginia

SOURCE: U.S. Maritime Administration

ate more taxes," Rodrigue says.

Instead of government arbitrating development, as Baltimore did, developers argue that buyers and sellers should determine the highest and best use of waterfront property. Anyone who is willing to put their money on the table should be allowed to redevelop a site, especially someone who wants to convert underutilized industrial space into housing or office space that is in demand.

Regardless of how these issues will be resolved, Fifth District ports are acutely aware of the competition they face. The next generation of larger container ships will be sailing the oceans in coming decades, and will require ports to get bigger and smarter to handle the growing volume of containers, or else develop other customer bases.

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shame

AND BANKRUPTCY

The number of Americans filing for bankruptcy protection has surged fivefold in two decades. A Richmond Fed economist challenges the conventional wisdom that declining stigma is at the root of the increase

BY DOUG CAMPBELL

“At one time in our history, filing bankruptcy was regarded as shameful, and filers suffered social stigma and permanently ruined credit. The shame and stigma are no longer compelling.”

— The Hon. Edith Jones, former member of the National Bankruptcy Review Commission, March 1999

“Stigma is by no means dead.”

— Kartik Athreya, economist, Federal Reserve Bank of Richmond, 2004

The narrative sounds convincing: Crazy consumers, their wallets stuffed with maxed-out credit cards, rack up unseemly sums of debt and then shamelessly unload it all in bankruptcy court. Back in the good ol’ days — say, the 1920s, 1950s or even 1980s — this never would have happened, the conventional wisdom goes. Americans had integrity. They certainly wouldn’t bail themselves out by the million with bankruptcy protection. Their reputations were too important. That was then. Nowadays, with bankruptcy increasingly commonplace, the stigma has faded. It’s an embarrassment of riches in reverse.

How else to explain skyrocketing bankruptcy rates? Consider the case of the 1990s. Personal bankruptcy filings surged 35 percent to more than 1.4 million a year in 1997 from 924,000 in 1991. The median total of unsecured debt borrowers discharged in bankruptcy in 1981 was \$12,452. By 1997, it had soared more than 50 percent to \$19,515. The pace of filings was eight times higher than population growth. (Business bankruptcies account for less than 3 percent of total filings.) That unemployment was low, the stock market rising, and the economy generally humming as bankruptcy filings accelerated left analysts reaching for answers. The stigma rationalization

PHOTOGRAPHY: COMSTOCK IMAGES

was as expedient as it was convenient. It squared with the gut feeling of many Americans that moral standards were falling. Credit cards had indeed become widely available, but why were so many people using their plastic with reckless abandon?

The trend continued into this century. In 2003, more than 1.6 million people filed for bankruptcy protection. By comparison, in 1983 only 286,444 Americans went bankrupt. About seven out of 10 debtors file under Chapter 7 bankruptcy protection, in which all their unsecured debts are erased. Chapter 7 filings account for \$36.4 billion of the total \$40 billion discharged each year in bankruptcy. Most of the rest comes in the form of Chapter 13 bankruptcies, in which payments for secured debts are rescheduled but still result in the discharge of most unsecured debt.

The Conventional Wisdom

The “declining stigma is the root of bankruptcy” way of thinking has gained currency. The winter 1999 issue of *Harvard Magazine* chimed in with a typical hand-wringing account: “Credit industry analysts hold that the stigma of bankruptcy has traditionally kept people honest about their ability to pay debts. Earlier generations of debtors lashed themselves to austerity budgets, sold off possessions, and worked extra shifts to avoid the shame of defaulting. But today, says the industry, many debtors have chosen to see bankruptcy as a convenient loophole against collections.”

Towson University economist Joseph Pomykala, in a 1999 article, offered up a virtual bankruptcy hall of shame: a doctor who filed for bankruptcy immediately after charging a \$60,000 European vacation on his American Express card; a waiter who accumulated \$170,500 in debt over just six months for items including a gambling trip to Atlantic City.

Funny thing is, this is old news. For decades, preachers, politicians, and ethicists of all stripes have railed about the decay of fiscal virtue. Economists Bradley Hansen of the

University of Mary Washington and Mary Eschelbach Hansen of American University note in a recent paper that worries about declines in stigma were shared by credit experts in the 1920s. The difference in the 1990s was the seemingly persuasive combination of shame and fast-increasing bankruptcy cases. The bankruptcy-and-shame theory officially entered the zeitgeist.

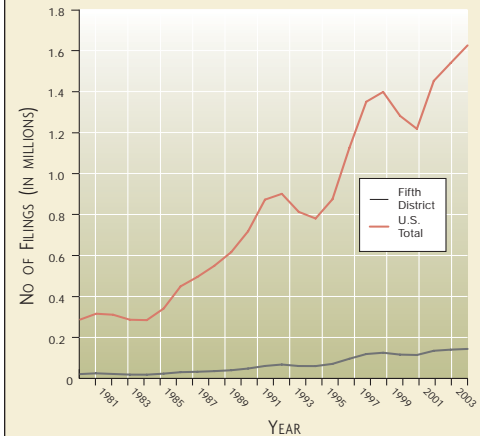
Intangibles like stigma aren’t usually fodder for number-crunchers. But it wasn’t long before economists began weighing in, albeit at first indirectly. David Gross of Lexecon Inc. and Nicholas Souleles of the University of Pennsylvania seized on a “demand-effect” explanation for escalating bankruptcy. People have become more willing to default over time in part because the costs of default, including nonmonetary costs like social stigma, have declined. Our work “is suggestive of a decline in social stigma or information costs, but it is not conclusive,” they wrote in an article published in the spring 2002 issue of the *Review of Financial Studies*.

Economists Michelle White of the University of California at San Diego, Erik Hurst of the University of Chicago, and Scott Fay of the University of Florida took that case to another level. White has long held that — shame aside — we should expect more people to file for bankruptcy because it is financially advantageous to do so. By her tally about 15 percent of U.S. households could gain from bankruptcy protection but less than 10 percent of those same households — and only a tiny fraction of all U.S. households — actually do. In their widely cited 2002 *American Economic Review* article, “The Household Bankruptcy Decision,” White, Fay and Hurst backed the “strategic model” of bankruptcy, which predicts that people file for protection not so much because of adverse events but because they see financial benefit.

White’s team took a stab at testing the bankruptcy-stigma theory. Basically, they found that people were more likely to file for bankruptcy

Consumer Filings

The steep climb in U.S. consumer bankruptcy filings (which also happened in the Fifth District) during the 1980s and 1990s led many to believe that people no longer felt shame in seeking court protection from paying their debts. A Richmond Fed economist attributes the rise to cheaper lending costs incurred by creditors.



SOURCE: Administrative Office of the U.S. Courts

when they lived in a district that had a higher filing rate relative to population. They argued that people are more likely to learn about bankruptcy from friends and family and to decide that bankruptcy is, by extension, socially acceptable if they live in a district with a higher filing rate. In an interview, White elaborates: “You get a subliminal message that it’s not stigmatized.”

So the issue seems largely settled: Bankruptcy is being accelerated by declining stigma. Well, not so fast. The debate over stigma’s role in bankruptcy is very much alive, and the implications for how it’s resolved are important.

The Challenge

Steering stigma-and-bankruptcy research in a new direction is Kartik Athreya, an economist with the Federal Reserve Bank of Richmond. His work leads him to conclude that it’s “shame as it ever was,” to borrow from the title of one of his recent papers.

Athreya says that bankruptcy rates are climbing because it’s much cheaper for creditors to make loans. As a result, riskier borrowers are eligible to accu-



Mounting consumer debt spawned big increases in bankruptcy rates during the 1990s. A Richmond Fed economist suggests that widely available credit — more so than falling stigma — was the driver behind the gains.

mulate levels of debt that in previous decades would have been unheard of. “If stigma really went down, it’s hard for me to understand creditors making loans on the favorable terms they’ve been making them,” Athreya says. “Declining stigma should have some impact on the cost of credit.”

Athreya is a relative newcomer to the shame-and-bankruptcy fray. Stumped for a dissertation topic in 1997 he took a year off from his graduate studies at the University of Iowa to work for Citibank’s credit card unit. One of his jobs was to figure out how much default the company should view as a simple cost of doing business, and how much ought to be either recovered or prevented from happening in the first place by not extending credit to risky consumers. Athreya headed back to campus the next fall with a fresh focus. Citibank had a specific business problem. What intrigued him was the wider role that bankruptcy played as an American institution. Was bankruptcy good for the country?

“Bankruptcy has always been talked about in terms of providing a kind of insurance or backstop against misfortune for honest people,” Athreya

says. “It’s got this really long history as an insurance product, broadly speaking, but the question that is of interest to economists is: Is this insurance product worth having around?”

Bankruptcy is of interest to economists because it’s supposed to be a safety net against all the hazards of modern-day life, from divorce to disability, and the consequences of maintaining this safety net are not to be taken lightly. Credit costs are higher for everybody because borrowers

always have the option to seek the sanctuary of bankruptcy court. To hedge their bets, lenders charge more.

In theory, economists say that in a world where shocks to people’s income are “transitory” — that is, temporary, surmountable setbacks like unemployment or brief illnesses — then it’s hard to justify a role for bankruptcy. In such a world, the costs of bankruptcy — making borrowing more expensive for everybody — outweigh the benefits an average person might obtain from being able to walk away from his debts. But those same economists concur that if income shocks are more severe and permanent, bankruptcy makes economic sense. And we see such shocks all the time: workers lose limbs in plant accidents; jobless mothers divorce and are awarded sole custody of their children. The ability of those people to dig their way out of debt is forever blunted, and so bankruptcy protection is the best answer.

On top of all this is the potential role of bankruptcy in fostering America’s entrepreneurial culture. Innovators must take risks, both financially and otherwise, and offering the option of bankruptcy court is viewed as an important part of cultivating entrepreneurship.

The Richmond Fed’s Athreya puts it this way: “We agree that bankruptcy in principle can provide people with

a type of insurance against certain outcomes. It makes them willing to borrow to tide over bad times. But if bad times persist, we give them an out through bankruptcy.”

Until recently, Athreya’s research had concentrated on the consequences of expanded unsecured credit combined with lax bankruptcy law. (He decided that it was a bad combination, helping a small number of poor people at the expense of other people in a manner that reduced overall welfare.) Additionally, he is looking into the interplay between U.S. social insurance programs like unemployment insurance and bankruptcy.

The trick with stigma was figuring a way to plug it into a mathematical model. Given that shame isn’t an observable statistic, like the unemployment rate or the gross domestic product, it’s quite a neat trick.

Here’s how he did it. First, he looked at some facts and found that from 1991 to 1997 bankruptcy rates roughly doubled. Next, he took the following actual data from 1991: bankruptcy filings, the median level of debt discharged in bankruptcy, and credit card charge-off rates. He then constructed a model designed to capture important factors influencing bankruptcy — including stigma — that approximately matched the 1991 data. Finally, he lowered the cost of stigma in the model to see what effects that produced.

When Athreya lowered the cost of stigma — as was supposedly happening in America during the 1990s — he came up with a bankruptcy rate of 0.18 percent in 1997, a close approximation to the actual 0.2 percent rate. But the model yielded results that were way off in terms of the level of debt held by Americans. In Athreya’s lowered-stigma model, the median debt-to-income ratio came out as 0.85 percent. In reality, it was 50 percent. Why the difference? In the model, when stigma falls and bankruptcy rates rise, lending becomes riskier. So lenders require a higher return to compensate for the increased risk. Facing higher interest rates, consumers become less willing to take on debt.

Then Athreya found a better fit. He ran the same exercise but kept stigma constant and cranked down the cost of lending money. Suddenly, actual and projected figures started matching. The projected bankruptcy rate was 0.19 percent (compared with the actual 0.2 percent) and the median debt-to-income ratio among filers was 40.3 percent (compared to the actual 50 percent).

Athreya's interpretation of these results is that in the first run, where stigma is lowered, "it becomes very expensive to get a loan in this era." By contrast, when stigma is held constant and the cost of issuing loans is reduced, the numbers start falling in place. "It's cheaper for creditors to figure out who they're lending to and to figure out information about their ongoing relationships," Athreya says. "This narrative fits together with a lot more facts that are observable than the stigma story does."

It also fits with other economic research. In a recent paper, economist Wendy Edelberg of the Federal Reserve Board documented the increase of high-risk borrowers taken on by creditors in the 1990s. Edelberg argued that technology-savvy creditors were able to in effect partition high-risk debtors from low-risk debtors by pricing them differently. In the end, this had the effect of "democratizing" credit, or lowering the cost of borrowing for a large population.

Methodological Questions

Athreya's research has turned a lot of heads, but it hasn't convinced every-

one. White, for one, isn't so sure that stigma is dead. "I'm not a simulation person. I'm not a fan of that approach particularly," she says, referring to Athreya's model.

"Stigma is still something we don't have any direct information about," White says. "It's hard to test very rigorously. There's a limit to what economists can do."

Within those limits, however, White tends to employ regression models — and therein lies her chief reservation about Athreya's research, which relies on simulation models. It's an ongoing debate among academics, and it is impossible to say with any authority which side is right.

In a nutshell, regression models use historical, empirical data in which households react the same way to market forces. By contrast, simulation models recalibrate household reactions to new market realities. For example: In football, historical data might indicate that lining up in "shotgun" formation would be a good idea all of the time, because in cases when shotgun has been used in the past the quarterback is seldom sacked. But in reality, defenses would adjust to offenses that always used shotgun formation, thus rendering the initial model's results pointless.

In favor of the regression approach are unassailable data: Every value plugged into a regression model is drawn from observable records. As such, regression is widely believed to be the best tool in evaluating big, con-

ceptual problems. But macroeconomists in particular consider the economy a miserable natural experiment. How can you possibly conduct a "natural" experiment in which some 10,000 values are fixed but one small variable is changed? That's what simulation tries to get around.

Athreya agrees that economic inquiries have their limits, but he remains satisfied with his research. He thinks it is the closest economists have come to identifying a value for stigma. And it advances the debate about what should be done, if anything, to reform U.S. bankruptcy policy. There may be no need, after all, for the breast-pounding over America's declining moral standards. "It's hard to figure out what shame looks like. That is what's allowed this story to exist for a long time. It floated in the ether and was hard to pin down," he says. "To kill stories like that you need stories for which everything is observable that fit the facts." Of course, the facts remain much in debate. Athreya, for example, concedes the distinct possibility that both declining stigma *and* declining transaction costs are at play in bankruptcy rates. "I can buy that," he says. "But then the task is, how big is the stigma? A small part? A big part?"

It takes a model to beat a model, Athreya says, and he has yet to see a model that discredits his. But he adds, "My model is certainly not the last word on this." The only shame would be in letting the inquiry drop. **RF**

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Cotton fields are giving way to development as commercial and residential communities pop up along Interstate 95 in Roanoke Rapids and Halifax County.

HARD TIMES

North Carolina's Northeast Counties Are Among the Poorest in the Nation. Can They Reverse Course?

BY BETTY JOYCE NASH

The Roanoke River helped channel colonial trade from the coast to the interior of northeastern North Carolina. It helped power textile manufacturing in the last century. Today, the river reels in more than \$3 million a year when fishermen hit Roanoke Rapids, N.C., looking for the rockfish that spawn in mid-March.

But Interstate 95 is the vein of commerce that's turning the economic tide today. It crosses the river and flows through the agricultural fields, leaving a swath of retail in its wake. Along the highway's edge in Roanoke Rapids, new development has cropped up on last year's furrows, including a Wal-Mart, chain restaurants, a cinema complex. Even a Starbucks is under construction.

Like much of the rural South, North Carolina's poorest counties, particularly the northeast cluster of Bertie, Halifax, Hertford, and Northampton, remain an economic desert when it comes to jobs, especially the technology-based work that has fueled economic progress in bigger cities. Single mothers of four make do on \$25,000 a year; others take jobs at multiple fast-food restaurants. Per-capita income is at 72 percent of the state average and 65 percent of the national average. And 24 percent of Halifax County people are poor, compared to 12 percent statewide. The federal poverty level is \$18,660 for a family of four.

These distressed counties lie too far from North Carolina's coast to win big

PHOTOGRAPHY: BETTY JOYCE NASH

from the coastal construction and tourism boom. They are isolated from the diverse job mix in cities like Raleigh, some 70 miles away. Poverty hides among the dilapidated barns and bushes and among decaying mill villages.

Rural residents face few job options, and the counties suffer from high illiteracy rates as the river of human capital rushes away from farms, fields, and former manufacturing plants into urban areas.

Job Country

Roanoke Rapids City Manager Rick Benton drives along a new stretch of road where harvested cotton fields lie adjacent to newly graded expanses of earth. He exchanges greetings with the proprietor of Twin County Powersports, set to open any day. In the distance is the Halifax Regional Medical Center, which employs 700 and serves about five counties. Benton explains that the new development in these fields probably will be medical offices. A residential community is also planned.

The city and county have invested in water, sewer and roads along the intersection of Interstate 95 and U.S. Highway 158 over the past seven years, even before the textile employers vanished. They're building a new airport, largely with federal funds. The city has an award-winning program to demolish or renovate homes in the mill village to increase tax base and reduce crime. They also developed an industrial site with a "shell" building, as economic developers do these days, to show business they mean business.

The work is paying off. Retail is popping; the shell building will be deeded to PCB Piezotronics, a sensor manufacturer which has pledged to come to town, if the firm meets investment commitments. And Benton spells out the significance of the stores, restaurants, and movies to rural residents.

"Before, if you wanted to shop, eat, and go to a movie, you had to drive to Rocky Mount," he says. Rocky Mount is some 30 miles away.

Shopping, eating, and movies, though, are only useful for people with extra money and the jobs to earn it. The

recent influx of retail jobs, economists say, is better than none. Service jobs — including retail — have replaced agriculture and manufacturing jobs throughout rural America. More than 93 percent of new full- and part-time jobs in nonmetro areas between 1990 and 1999 were generated by service industries, according to the Southern Rural Development Center. But who's complaining? Halifax County is down to a 9 percent unemployment rate at the end of 2003, compared to a high of 12 percent unemployed in 2002.

"We've gained more jobs than we lost, but a lot are retail and not as high paying with good benefits as industry jobs," Benton says. "We feel like now we've positioned ourselves with investments and infrastructure with PCB coming. They will create a world of opportunity."

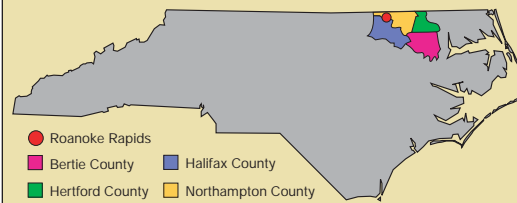
The coming of commerce also includes other venues such as a Lowe's distribution center in neighboring Northampton County and Nucor Steel in Hertford County. And Halifax County recently gained a company that makes blinds, as well as PCB. Over the next decade, PCB plans to employ at least 500 people in jobs averaging \$26,000 a year with benefits. Officials hope PCB will complement a public/private investment, the North Carolina Advanced Vehicle Research Center, slated for neighboring Northampton County. But PCB aims to start with only 30 local people, so it will take a while for the multiplier effects to build.

Job creation is the mantra for distressed rural communities where drastic declines in agriculture and textiles have left many an unskilled 50-year-old jobless and many a local government with insufficient tax base. And a bleak employment picture motivates the most valuable asset — educated people — to leave if they can.

"With jobs, the more money that flows in, the better off you are, all other things equal," says Mitch Renkow, an economist at North Carolina State University. "If you have a lot of people who are highly educated, you'll have a higher number of [better paid] jobs. [You'll]

Northeast by the Numbers

Many of the counties in northeast North Carolina have per-capita income figures well below and poverty rates well above the state and national averages.



County	Per-Capita Income	Share of Population Below Poverty Level
Bertie	\$14,096	23.5%
Halifax	\$13,810	23.9%
Hertford	\$15,641	18.3%
Northampton	\$15,413	21.3%
North Carolina	\$20,307	12.3%
United States	\$21,587	12.4%

NOTE: Data presented are from 1999.
SOURCE: U.S. Census Bureau

textile industry employed 4,000 people at one time. But in 2002, the county's unemployment rate reached 12 percent compared to 6.7 percent statewide as the mill's operations dwindled, then ceased altogether in 2003. And the jobless bring unpleasant realities: Almost 11,000 people — 19 percent — receive food stamps.

As local economic development efforts concentrate on luring jobs, it's important to identify who actually gets the jobs, according to Renkow. It turns out that it's not always local people. Renkow has studied labor market adjustment to employment opportunities in the state and found that the previously unemployed take fewer than 2 percent of new jobs in a county.

Many new jobs in rural counties are filled by residents who formerly commuted elsewhere, approximately 37 percent. New in-commuters take 32 percent of the jobs and new residents fill nearly 29 percent, according to Renkow's findings.

Such worker mobility means that workers in one county will benefit from the success of another nearby county, another reason why it's critical for counties to cooperate when recruiting.

"Rural counties have a little leg up,

having those jobs stay at home,” he says. By contrast, in metro counties new in-commuters take a whopping 51 percent of new jobs.

Today’s pitch for the good jobs includes education and training. But it wasn’t always so. In the early days of industrial recruiting, companies flocked to rural areas where workers had little

formal schooling. People worked cheap and lived well and had little incentive to educate themselves. And they’re paying for it now.

The Learning Curve

When Northern industries moved south, it was because of cheap labor, notes Richard Brockett, associate

director for economic development at East Carolina University.

“Mill jobs were either second jobs, or people who worked on the family farm found employment there,” he says. “It didn’t take a lot of education to do it. Those jobs have left and [jobs in] farming are fewer and fewer.” The remaining population is trapped.

Like Freida James, who is folding her laundry at the laundromat on U.S. Highway 158. James has a steady job at one of the area’s prisons. But she hasn’t gotten a raise in four years and she supports four children ages 4 to 11 and herself on about \$25,000. She doesn’t want to leave the area because her parents live there and she reasons that even if wages are higher elsewhere, so will the cost of living be. She has friends who are unemployed and friends who work at fast-food restaurants.

“I know one girl working at Wendy’s and KFC both,” she comments.

North Carolina’s community colleges receive state funds to train workers for new and expanding industries. However, state incentives have not guided industry to distressed counties. According to a recent report by the North Carolina Budget and Tax Center, urban counties have been the biggest beneficiaries of state incentives. Sensor manufacturer PCB was brought in through sizable state and local incentives.

For example, Halifax County has agreed to upfit the shell building at \$1.5 million, and the city, along with a business nonprofit, will contribute \$90,000 to help relocate families. And the state offered a Job Development Investment Grant worth \$1.6 million over 10 years in the form of annual grants equal to 65 percent rebates on state income taxes paid by workers in the new jobs, if the company meets performance targets.

This is more than Southern hospitality — it’s a sign that these are the kinds of jobs rural areas need, but have been hard to attract.

“One of the most important problems...is that the kind of firms that pay good wages want a quality level in their work force that may not be available

Foundation Fosters Entrepreneurship in Rural North Carolina

Phillip Horne grew up in Northampton County, and his parents still live on the family peanut farm.

“I will never forget the day my father sat me down and said, ‘I am sending you away to go to school so you will not have to do this,’” he recalls his father’s words 30 years ago.

“He probably knew in his heart of hearts that I would be a lousy farmer,” Horne quips. “I had no idea until I left the farm and went away to an urban setting to go to college how impoverished my region was.”

Today, Horne is president of the Foundation of Renewal for Eastern North Carolina (FoR ENC). The group, bankrolled by private investors who back business in exchange for equity, began two years ago to stimulate the culture of entrepreneurship in eastern North Carolina. The group’s board is co-chaired by Kel Landis, former chief executive of RBC Centura Bank, and Phil Carlton, a former N.C. Supreme Court justice and one of the people who helped broker negotiations with the tobacco industry.

The mission is to grow intellectual capital as well as to attract money to transform vision into reality. The group began with about half a million dollars and currently has a net worth of about \$1.8 million, Horne says. “We feel we’ve done a lot with a little.”

Venture investments include Wavelength Broadband, which is entering its second round of investments and Edenton, N.C.’s, Broad Street Software Group, which hopes to go public within the next 18 months. Such investments, Horne hopes, will stimulate clusters of knowledge businesses. They’re also part-

ners in a small firm that salvages heart pine from old tobacco barns and factories to restore for contemporary projects. The business, Our Heritage Preserved, was recently featured on an NBC News segment.

Thinking big and small at the same time seems to be FoR ENC’s specialty. Perhaps one of FoR ENC’s most ambitious and visible projects slated for eastern North Carolina is the Fund for New Urbanism, Sandy Point, a project planned by the world-renowned architectural firm Duany Plater-Zyberk. The firm, according to Frank Dooley of FoR ENC, was casting about for a location outside of Florida and a friend introduced the group to one of the principals. The model community for visionary regional land planning will sit on nearly 1,000 acres adjacent to Albemarle Sound, three miles from Edenton. FoR ENC plans, with partners, to create an Institute for Eastern North Carolina on-site.

It’s a natural for the area, says Horne: “Sandy Point is a model for what Eastern North Carolina already is ... we are a series of inner banks towns. All were originally planned along a traditional neighborhood grid.” New Urbanism seeks to recreate a sense of community, with shops and workplaces and homes within walking distance. “It’s already been proven the creative class is dying for towns like this,” Horne says. “What we’re trying to say is we have the raw materials ... we can create new microeconomic systems that accommodate knowledge workers.”

Only two years old, Frank Dooley says FoR ENC is just getting warmed up. “We can rock and roll like the Triangle.”

—BETTY JOYCE NASH

in Halifax or Northampton counties,” says Renkow. “You have this brain drain phenomenon, where the smart kids go to the cities. First of all, if you’re a smart kid in Halifax County, you’re going to go somewhere else to go to college. And then you’re going to stay there.”

It’s a chicken-and-egg problem, says Mike Luger, director of the office of economic development at the Kenan-Flagler Business School of the University of North Carolina at Chapel Hill.

“For a healthy economy, the key elements are that the jobs being produced are appropriate for the labor force today, and lead to opportunities for higher skill value in the future,” Luger says.

There’s the rub. In Halifax County, roughly 35 percent of people 25 or older haven’t finished high school, says Lyndal Williams, dean of continuing education at Halifax Community College. Only 11 percent hold at least a bachelor’s degree, about half the state average of 22.5 percent. Average Scholastic Aptitude Test scores are the worst in the state: Students scored 782, compared to the state average of 1,001.

And there’s no telling how many people can’t read. No good data are available, says Williams. She’s been involved with retraining textile workers. “Their benefits are now playing out, so they are going to be trying to get into another labor market,” she says. For example, a class called environmental services trains people to wax and buff floors for businesses. At least one student started his own floor service business, she says.

People in the community are hungry for jobs. When PCB Piezotronics held its first job fair last fall in



Mayor Drewery Beale (right) and City Manager Rick Benton of Roanoke Rapids stand alongside a trail that runs for eight miles adjacent to the old canal bed that once brought trade inland.

Roanoke Rapids, it drew 1,600 people. The lucky few who will be hired will undergo months of training for the microscopic assembly work.

Enhanced education is linked to economic growth. Although economic development returns to education are greater in metro than nonmetro areas, an educated labor force is essential to a healthy economy in rural areas, too, economists have found.

The idea is that higher levels of human capital attract new business, enable existing local firms to pivot when technology and conditions change, and promote entrepreneurial activity, according to economists David Barkley and Mark Henry at Clemson University.

An educated labor force also stimulates networking and the spread of ideas, critical to the success of cluster development. The authors found that an increase in the number of adults with some college was associated with more rapid employment and per-capita income growth rates for urban and

rural areas. On average, a 5 percent increase in adults with some college resulted in 4,684 new jobs in metro areas and 150 new jobs in nonmetro counties, the authors found.

While those are modest gains, 150 new jobs in a county where unemployment is high are welcome, especially if those jobs come with benefits and the chance of upward mobility.

The people in Roanoke Rapids and Halifax County who have worked to improve the economic climate believe they’re finally ahead. Losing a turf mentality helped, but it wasn’t easy.

“Regionalism has a tough time taking hold in areas that don’t have a whole lot going for them,” Brockett says.

But tourism director Lori Medlin, who returned to her native Roanoke Rapids to marry and raise her family after 10 years in New York City, says she’s earned a place at the economic development table. “That wasn’t the way it was when I first came here in 1995.” And it’s because tourists spent \$57 million in Halifax County in 2003, a 35 percent increase since she arrived that year. Visitors include eco-tourists who kayak or bird watch at the world-renowned sanctuary in Scotland Neck, hunters and fishermen, and history buffs interested in the Halifax Resolves, the first action by a colony urging independence.

In rural areas, it’s unlikely that a big fish will come along and pull everyone out of the ditch. So it makes sense to encourage even a minuscule piece of the economy.

“When you make a ripple in a small pond,” Brockett says, “it can make a difference.”

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Happy trails

Horses are used more for pleasure than business, but they still have a place in Fifth District agriculture

BY CHARLES GERENA

Late July in Leesburg, Va., is fairly hot for outdoor activities, but the annual Summer Dressage Classic is in full swing at the Morven Park International Equestrian Center. One rider outfitted in classic equestrian gear — black boots, white breeches, black jacket, and show helmet — circles the outdoor arena on her horse. A woman stands with a clipboard and calls out different maneuvers for the rider to perform. In an adjacent arena, spectators stay cool under a tent while they watch another horse and rider work in unison.

Kentucky may be called the “horse capital of the world,” but the horse industry has left its hoof prints in Leesburg, other parts of Northern Virginia, and elsewhere in the Fifth District. Conservative estimates from the U.S. Department of Agriculture put the district’s equine population at 244,000. That number includes only animals on farms, not those living at racetrack stables or in horse lovers’ backyards.

While horses remain part of agriculture, they are no longer merely inputs of farm production. The American Horse Council says there are 6.9 million equines in the United States, based on an impact study it commissioned in 1996, but less

than a third of them are used commercially. The remaining 4.9 million are for personal recreation and showing.

Ever since automation reduced the number of farm animals necessary for manual labor, the satisfaction that people get from their equine companions has provided a new foundation for the horse industry. “Driving through the woods on a horse on a crisp fall day, there is nothing like it,” says Mary Ellen Tobias, an equine marketing specialist for the South Carolina Department of Agriculture and a horse lover since the age of 3. “Once it gets in your blood, it’s a love that you can’t imagine.”

In fact, the recreational uses of horses have helped their numbers rebound and grow. New businesses have formed around these uses, generating millions of dollars in expenditures on feed, fencing, and other goods and services. According to the most recent statewide surveys, purchases by the horse industry totaled \$335 million for North Carolina in 1996; \$505 million for Virginia in 2001; \$766 million for Maryland in 2002; and \$104 million for West Virginia in 2003. (South Carolina is in the process of compiling its first equine survey.)

Horse Of A Different Color

Horses started out as work animals. At their peak numbers in 1915, 21 million horses and mules plowed fields, hauled people and goods, and performed other tasks.

In the Fifth District, plantations began relying on horses and mules during the 19th century as farming shifted from using human power to animal power and labor-saving devices like steel plows. In fact, many plantations continued using horses for harvesting and transportation well into the 20th century, as mechanization progressed slowly in Southern agriculture. The region’s fertile soil enabled farmers to provide pastures and grow hay, straw, and grains for their equines.

Agriculture continued to change as the 20th century progressed, and so did the horse industry. “With the advent of motorized vehicles and mechanized farm equipment, [the number of equines nationwide] plummeted to about 2 million by mid-century,” remarked the authors of a 2001 study on the horse industry in Montgomery County, Md. “However, the number of horses soon began to creep back up. The difference was that their primary

role had changed from beast of burden to pleasure mounts.”

Today, people enjoy their horses in a variety of ways, from the formality of equestrian shows to the thrill of a steeplechase. As animal sciences professor Thomas Hartsock puts it, they occupy the “fun” niche of agriculture that exists alongside the traditional “food and fiber” activities of farming. Hartsock, director of the Institute of Applied Agriculture at the University of Maryland-College Park, puts the horse industry in the same recreational category as horticulture.

One of the most popular activities for horse lovers in the Fifth District is dressage. At events such as the one held at Morvan Park, riders are judged on how well their horses follow specific movements. The original intent of dressage was to aid cavalry officers in preparing their steeds for battle.

Other popular activities include trail riding, showing, and eventing, an “equestrian triathlon” that involves dressage, show jumping, and navigating an obstacle course. Two of the five members of the 2004 U.S. Olympic team for eventing were from Virginia, while a rider from North Carolina served as an alternate.

Some people still keep horses on their own property and take care of them, but others don’t know a thing about animal husbandry or equine health. They view horses as a means to an end — an opportunity to enjoy the outdoors, spend some time with animals, or get a dose of excitement.

As a result, the “horse farm” emerged to serve their needs. The Montgomery County study noted that when horses were just work accessories, they were rarely the primary focus of an agricultural operation. Today, taking care of horses is big business — about 100 horse farms provide boarding, training, and instruction in Montgomery, mostly north and west of the county’s seat in Rockville.

Equestrian centers provide similar services in addition to hosting sporting events and shows, though they typically receive financial assistance from private foundations and government agencies that wish to support equestrian activi-

ties. Other businesses also have emerged to provide goods and services.

The recreational use of horses has not only generated new economic activity within agriculture, but also has helped traditional farming by providing alternative sources of demand for crops used for food and bedding in stables. James Steele, chairman of the Maryland Horse Industry Board, notes that when grain prices fall, many farmers switch to growing hay and straw for horses.

Local farmers typically supply horse owners with agricultural goods, but these crops can come from anywhere in the country. Northern Virginians have been importing hay from as far away as Canada because production in the region isn’t meeting demand.

Following The Money Trail

Generally, horse owners spend much of their money locally and regionally. In his 2000 analysis of eight Maryland counties, agricultural economist Malcolm Commer Jr. at the University of Maryland found that at least 75 percent of spending by horse owners is within their counties of residence and 80 percent is within the state.

Where does this money go? Typically, it’s spent locally at retailers that supply a variety of goods, from harnesses and saddles to fences and barns. It also goes to farriers who shoe horses, veterinarians who provide equine care, trainers, and other service providers.

Trail riders usually have paths to explore close to home, but they occasionally travel looking for new territory. Those who enter their horses at equestrian shows and sporting events sometimes also take their dollars on the road. When they travel for competitions, they may spend money on entrance fees, parking space and stable rentals, gasoline for vehicles, and hotel rooms. In either case, the economic effect is similar to tourists visiting Pinehurst, N.C., to play golf or the New River Valley in West Virginia to ride the rapids.

In contrast, the spending of people who breed horses more closely resembles traditional agricultural producers. Once a breeder with a mare pays a stud fee to have a stallion supply his seed, the

mare has to be fed, housed, and trained on a farm until she gives birth to a foal. Then, the foal has to be raised for more than a year before it can be sold. Breeders who sell the reproductive services of their stallions also spend money to raise their “products.” Also, those without a breeding facility have to rent one in order to have a controlled environment for equine coupling to take place.

In addition to the activities of horse owners and breeders, there are the spectators who attend equestrian competitions. In Maryland, for example, thoroughbred and harness races drew 2.4 million people in 2002 compared to 2.7 million who attended home games of the Baltimore Orioles that year. The middle leg of the Triple Crown, the Preakness Stakes, packs the stands at Pimlico yearly with more than 100,000 horseracing fans.

Racing is a big component of the spectator sport aspect of the horse industry. In addition to buying food and paying for parking, fans add to the excitement of a race by placing bets on their favorite thoroughbred. Maryland, Virginia, and West Virginia permit wagering at their combined 11 racetracks. In addition, West Virginia’s tracks offer slot machines, which generate extra revenue and enable them to offer larger purses that attract the best competitors.

There are the big spenders who pay a small fortune to buy or breed horses for racing and other equestrian sports. But contrary to popular belief, the horse industry is not dominated by millionaires. The American Horse Council’s study determined that horse-owning households had an annual median income of \$60,000, putting them squarely in the middle-class bracket. Moreover, while one-third of these households earned more than \$75,000 a year, one-third earned less than \$50,000.

A horse owner does need to have a sufficient amount of discretionary income to cover expenses. “You have to pay for food, clothing, and shelter before you do anything else, whether it’s going to the movies, going out to eat, or riding a horse,” says Cindy Wadford, executive director of the North Carolina Horse Council.

Horse Country

The economic effects of horse-related activities are felt throughout the Fifth District. But there are some places where it is more concentrated, areas that are affectionately known as “horse country.”

Since most horses are recreational in purpose, a lot of them are found near large population centers. “The horses are going to follow the people, and the people are going to be congregated around urban areas where the good jobs are,” says University of Maryland’s Thomas Hartsock. “In our state, large concentrations of horses are in central Maryland, literally an hour or an hour and a half drive from Baltimore or Washington, D.C.” Similarly, the counties in North Carolina with the most horses are part of major metro areas, including Greensboro-High Point and Charlotte.

Don’t look for a lot of horse-related spending in big cities, though. People usually enjoy their horses in nearby suburbs and rural areas where there is room for trails, stables, equestrian centers, and racetracks.

Some of these communities have developed enough “horse infrastructure” to become hubs of equestrian activity. They include Loudoun and Fauquier counties in Virginia; Baltimore and Montgomery counties in Maryland; and Southern Pines and other parts of the Sandhills region in North Carolina.

Some of the clustering is due to favorable climate and terrain, and in other instances due to lobbying for private and public support of equestrian centers and trails.

Such efforts have become increasingly important as denser development

Where The Horses Roam

Registered Horses Per 10,000 People

	Quarter Horses	Arabians	Paints
Maryland	15.5	5.7	0.3
North Carolina	50.7	8.2	1.0
South Carolina	45.4	6.4	1.3
Virginia	32.7	9.1	0.5
West Virginia	53.6	8.6	1.5
United States	97.3	10.9	1.6

SOURCES: U.S. Census Bureau, American Quarter Horse Association, Arabian Horse Association, American Paint Horse Association

extends into the countryside. Real estate values have skyrocketed in communities on the outskirts of urban areas, resulting in huge subdivisions popping up in between horse farms. “Horses live on relatively high-dollar acreage as compared to traditional farms,” says Hartsock. “It’s expensive land because people want their horses to be near where they live.”

This has raised the bar for horse ownership in places like Leesburg in Loudoun County, which is just 25 miles west of Washington, D.C. As the fastest-growing county in the nation, Loudoun lost 41,848 acres of farmland between 1987 and 2002, with almost half of that loss occurring in the last five years.

Andrea Heid, program manager of the Virginia Horse Industry Board, thinks tough decisions will have to be made in Loudoun. Development could continue unabated, which could result in only higher-income residents being able to afford land for their horses, or the county could preserve land for agriculture through zoning, which has its own costs and benefits. (See the downzoning feature in the Summer 2004 issue.)

In addition to access to land, capital can be hard to get for horse-related businesses. “Some people looking for

loans don’t have a strong business background,” says Lisa Derby Oden, a New Hampshire-based consultant for equine businesses. Oden and others say these firms don’t have a business plan or do other things to demonstrate that their enterprise is more than just a hobby.

Also, borrowers must have sufficient assets to pledge, such as equipment and real estate.

Horses usually make lousy collateral because there is no commonly accepted method of valuing their physical traits.

Other sources of capital are available for horse-related businesses. They include the federal Farm Credit System, a network of financial institutions that specialize in lending to the agricultural sector; and the U.S. Small Business Administration’s Microloan program, which has more flexible collateral requirements. Additionally, loans from state agricultural departments are usually open to the horse industry, except for those backed by the federal Farm Service Agency (FSA). FSA guarantees cannot finance the production of horses for “nonfarm purposes” such as racing and showing, nor can they fund nonfarm enterprises like riding stables.

Despite these challenges, the horse industry continues to thrive in the Fifth District and across the country. Whether they’re in it for business or pleasure, the people who work with horses say it’s worth the not inconsiderable trouble and expense. “Most of the people that I know do it because they have a passion for anything that’s equine,” says Andrea Heid. “A lot of them say, ‘I used to be rich before I owned horses.’” **RF**

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The Border Line and the Bottom Line

BY BETTY JOYCE NASH

Swift Creek has resisted annexation by its neighbor, the Town of Cary, N.C., for more than 20 years. Anti-annexation advocates say they want to keep development at bay and protect the community's groundwater supply.

"Cary is nibbling away at Swift Creek," says Tom Vass, president of the Middle Creek Swift Creek Community Alliance Inc. "Cary's concept of progress is to put shopping centers on every surface," Vass complains, adding that the runoff pollutes groundwater, affecting residents' wells.

The ongoing dispute over Cary's effort to annex Swift Creek highlights similar battles throughout the nation. Annexation brings up a host of emotional and economic issues: people who live in suburbs and use city amenities for free; continued decline of urban tax base; problems of monopoly as cities become bigger providers of services with less competition; and people's loss of choice when forced annexation overrules preferences.

State Laws Shape Annexation Behavior

Annexation is a time-honored way for cities to protect tax base, credit rating, and economic vitality. Some states let cities annex without residents' permission, especially if residents of land to be annexed already use — or want — city-provided services such as water and sewer.

But some states don't allow cities to annex. Cities that are surrounded by already-incorporated areas — preventing expansion — are hard-pressed to amass revenue to provide decent services and maintain aging infrastructure.

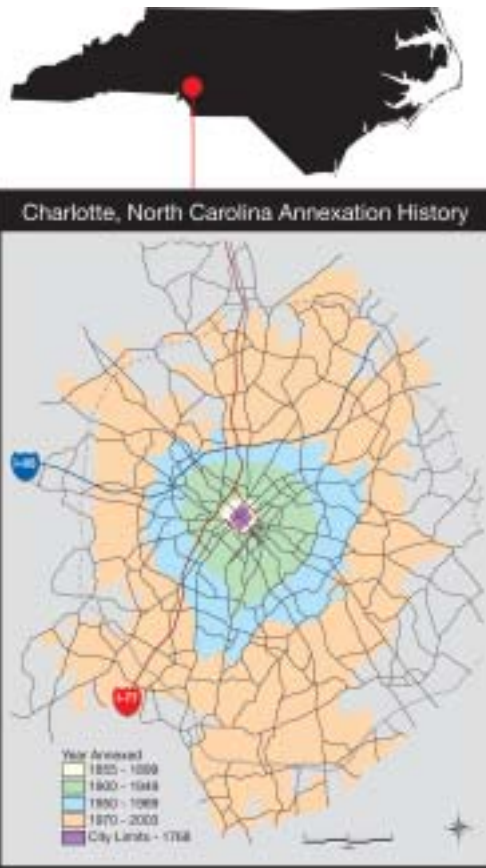
Middle-class people in the last half century have exited cities, siphoning off tax base and civic energy. Growing

cities have flourished through ever-expanding boundaries. The 50 top annexation-happy cities tripled their municipal area between 1960 and 1990.

Charlotte serves as an example. Its land mass has more than tripled since 1970, from 71.5 square miles to its current 268 square miles, thanks to North Carolina's liberal annexation laws. Those laws are among the loosest in the nation.

While the history and evolution of state annexation statutes are murky, they fall into several distinct categories. People, cities, a judge, or a legislative body can decide how annexation proceeds. In the Fifth District states of Maryland, West Virginia, and South Carolina,

The Economics of Municipal Annexation



Charlotte, N.C. has grown geographically from about 71 square miles in 1970 to some 268 square miles today. North Carolina's annexation laws are among the most liberal in the United States.

SOURCE: Charlotte-Mecklenburg Planning Commission

residents of the proposed annexation area get to vote on the issue.

In Virginia, cities can't annex at all, and a circuit court panel decides on towns' boundary changes. North Carolina lets cities, once certain conditions are met, absorb unincorporated urban areas without permission from the affected residents. And in the District of Columbia, which originally was created by the ceding of land from Maryland and Virginia, the issue of annexation is moot. (See sidebar on the origins of the District of Columbia.)

Naturally, when people get to decide whether to be annexed, as they do in 26 states, they usually nix the idea. Almost no one wants to pay the higher taxes associated with living inside city limits— or be told where to live.

Annexation Economics

Few laws dictated annexation behavior until the 20th century, says David Lawrence, an attorney who is an expert on the issue at the Institute of Government at the University of North Carolina at Chapel Hill.

"There were many cities incorporated in colonial times that kept their same boundaries for decades," he says. "When they did want to annex, it tended to be ad hoc, where they'd go to the

legislature to get specific authority." Annexation petitions multiplied and entire contingents, for and against, would migrate to the state capital seeking special legislation. In 1947 the North Carolina legislature authorized cities to annex, but also allowed the people being annexed to force a referendum. The legislature established a commission to study the issue, and 12 years later passed the law that is used today.

"[It's] based explicitly on the notion that people who live in a nearby city are there because the city is there and they share the benefits the city creates by being a cultural and economic center," Lawrence says. The rationale is that the whole metro area is a single community and the area to be annexed, as a tiny part of the metro area, shouldn't have veto power. "There have never been many states that let cities annex like that." Most states, evident by the number that require a popular vote before annexation, adhere to the idea that people ought to have a say so.

That's a popular notion in North Carolina, too, and one of the reasons why its annexation laws recurrently come under attack, Lawrence notes. North Carolina's annexation-friendly laws are continually questioned by people who live in territory within range of a growing city. Annexation dis-

putes are ongoing in Cary, Fayetteville, Goldsboro, and Winston-Salem.

The idea that people who live in suburbs benefit from economic activity that characterizes the city is widely accepted. The region couldn't exist without its hub, the city. That creates an economic problem of "free riders," people who use a city's goods — its streets, parks, cultural institutions, and the unquantifiable benefits of city life in general — without paying.

"If I happen to live outside the city limits and commute into downtown Charlotte, in effect what I'm doing is taking advantage of services provided by the city without paying for those services," says Jonathan Wells, capital facilities program manager of the Charlotte-Mecklenberg Planning Commission. "If I go out to the park and eat lunch out there, that park is paid for by the city." Suburbanites, however, patronize businesses and add to the city's tax base as well as provide labor.

Another problem with forced annexation is absence of choice and voice. Vass has lived in Swift Creek, 10 miles south of Cary, since 1978, and has seen bits of Swift Creek pulled into the town over time. Cary has grown from about 10.6 square miles in 1981 to about 45 square miles by 2002. Vass picked out where and how he

Inside the Beltway

The location of the nation's capital was a point of contention for some 25 years, floating from Pennsylvania to New Jersey, among other locales, until 1790 when a deal was struck between Alexander Hamilton and Thomas Jefferson. In exchange for federal assumption of largely northern state debts, the capital would be placed below the Mason-Dixon Line, along the Potomac River, on land given to the federal government by the two slave-holding states of Maryland and Virginia.

Initially, the area authorized for the new city was 100 miles square. The first commissioners named the city Washington, after the nation's first president, and decided to call the entire area the District of Columbia, after Christopher Columbus. The area also included the cities of Georgetown and Alexandria. In 1846, the area that's now Alexandria and Arlington County was ceded back to Virginia, shrinking the federal district by one-third, about 32 square miles. Apparently, Alexandria merchants had expected to win big through capital connections, but the economic activity never materialized because of disputes over the canal and competition with

the port of Georgetown. Also, the slave trade was booming in Alexandria, and dissociation from congressional authority allowed that trade to continue until it was outlawed.

The District is surrounded by mostly flourishing suburbs. But like other old urban centers, Washington D.C. has a higher poverty rate than the national average, 17.6 percent compared to 12.1 percent. In the early 1990s, the District faced financial woes that brought on management by a federal financial control board. With some 30 percent of its property owned or occupied by the federal government, that's a big revenue drain come tax time. However, D.C. levies a complex array of sales taxes to help offset "free rider" problems. For example, restaurant meals, rental cars and telephone calling cards come with a 10 percent sales tax. Commercial parking costs an extra 12 percent in local taxes, and like many other big cities, D.C. charges hotel guests a hefty tax of 14.5 percent.

Residents of the capital city can vote in presidential elections, determining who will receive D.C.'s three electoral votes. But they do not have formal representation in Congress. — BETTY JOYCE NASH

wanted to live, and yet may become part of an area that differs from his choice. What irritates Vass most is the idea that the people most affected don't have a say.

In that vein, economists Gaines Liner and Rob McGregor of the University of North Carolina at Charlotte report: "Since many people are living in unincorporated municipal fringe areas specifically to avoid paying higher city taxes, annexation effectively thwarts the preferences these residents have revealed in their choice of where to live." Further, they note that resources in the city could go to pay for service to newly annexed areas, leaving inner city residents worse off.

But Liner and McGregor also suggest there could be an optimal level of annexation at which per-capita taxes and spending are minimized. Liner and McGregor used data from 450 municipalities with populations of at least 25,000 over the decade between 1970 and 1980. For the lowest growth in per-capita spending and taxes over 10 years, a city would need to add land area from 78 percent to 93 percent of its area. The authors note that the approach does not take into account that the optimal annexation rate might not be the same for large and small municipalities.

"If you don't annex at all, costs per capita tend to be high," Liner says. "Annex some and they tend to come down. More annexation than none tends to reduce per-capita cost. To have the lowest increase, you have to annex quite a bit."

At some point, though, inefficiencies in service provision may develop as a city keeps getting bigger, and in that case, per-capita taxes and spending will begin to increase with annexation, the authors note.

The Politics of Annexation

After World War II, annexation activity proliferated. New suburbanites sought services they'd become accustomed to when they flocked to the city before, during, and immediately following the war. In the decade between 1950 and 1960, about 90 percent of the nation's cities grew through annexation.

Annexation laws are partly linked to the power of rural areas in the first half of the 20th century as well as to the power delegated to local governments by the states. In Virginia, where the Jeffersonian idea of the gentleman farmer held sway, cities were thought of as dens of iniquity where the poor country boy went to get fleeced, jokes Ted McCormack. He is associate director for Virginia's Commission on Local Government, the body charged with overseeing boundary line changes in the state.

"Thomas Jefferson always referred to cities as fetid sewers," McCormack says. "They were centers of gambling, prostitution, illegal trade, and so forth."

Virginia's unique system, where cities exist separately from counties, exacerbates the divide between suburb and city. The people who possessed political power were in a position to protect rural counties until one-man, one-vote court decisions in the 1960s gave city populations more representation.

Virginia's unique political geography has meant that annexation is much more contested than it would be in North Carolina or anywhere else because whatever a city gains in territory or tax base, the county loses, according to John Moeser. He is a professor of urban studies and planning at Virginia Commonwealth University and co-author of *Politics of Annexation: Oligarchic Power in a Southern City*.

In 1970, Richmond annexed 23 square miles and 47,000 people of Chesterfield County in what would become, in Moeser's words, "the most celebrated municipal annexation in history." The annexation seemed sensible on its face, as the suburban area had obvious ties to the city. Yet the action was rife with political intrigue and the politics of the day.

The negotiations for annexation had been conducted secretly for five years beforehand by people who wanted to retain a white majority on the city council, according to Moeser's book. A civil-rights activist sued, protesting that the annexation violated the 1965 Civil Rights Act by diluting black voting strength. Richmond City Council elections from 1970 to 1977 were suspended. The annexation was upheld by the U.S. Supreme Court, which mandated a ward-based voting system. The 1977 ward elections gave black people their first council majority and Richmond its first black mayor.

Today, many cities in Virginia, as in other parts of the nation, are left with old industrial sites, aging infrastructure, and a population with lower incomes than people who live in the suburbs. Nationwide, suburban median income is 67 percent higher than central city median income, according to Bruce Katz and Katherine Allen of the Brookings Center on Urban and Metropolitan Policy. Today, Richmond encompasses 62 square miles, while neighboring Chesterfield and Henrico counties smear out over 400 square miles and 200 square miles, respectively.

"The suburbs do not want the problems of the city," Moeser says. "The upshot is you've got cities in Virginia — Petersburg, Richmond — experiencing enormous fiscal stress with a declining tax base, jobs eroding, cities struggling." **RF**

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Frank Sloan

Editor's Note: This is an abbreviated version of RF's conversation with Frank Sloan. For the full interview, go to our Web site: www.rich.frb.org/pubs/regionfocus.

Type “health care” into a Google search and you’ll get more than 24 million web pages devoted to the subject. That’s not surprising given the personal stake that Americans have in how the economy supplies this vital service.

For most of his career, Frank Sloan has studied the health care industry using the analytical tools of a public policy economist. His goal has been to describe how government policies, along with economic factors, shape the decisions of people who provide and purchase health care. After 30 years of teaching and conducting research at universities around the country, Sloan returned to near his hometown of Greensboro, N.C., in 1993 to continue his work at Duke University.

Sloan has served on several advisory boards and committees, including the editorial board of the *Journal of American Health Policy* and the Physician Payment Review Commission, which was formed by Congress to evaluate Medicare’s physician reimbursement system. He also has spent 22 years as a member of the Institute of Medicine at the National Academy of Sciences, where he has co-chaired committees studying nurse staffing and vaccine development. His current research interests include alcohol abuse, long-term care, analyses of the cost-effectiveness of medical technologies, and medical malpractice. Charles Gerena spoke with Sloan on Nov. 8, 2004.

RF: Much of your research has focused on factors that influence the cost, quality, and utilization of health care. Do you think this market is fundamentally different from other markets?

Sloan: There are things that set it apart, but some people go off the deep end and say there’s nothing we can learn from other markets. One thing that health care and other markets have in common is that people respond to incentives. Another thing is that competition may produce some desirable outcomes. Markets won’t take care of poor people, but they are a way to achieve efficiencies.

What is different about health care is the uncertainty of consumption. You don’t know today that you might have surgery in two months, so that leads to demand for insurance.

Insurance stands between the people who provide health care services and those who use them, but it’s possible to oversimplify that relationship. Compulsory auto insurance is a way that we are able to tax those people who drink a lot and drive under the influence. The difference is that we find it socially OK — in fact, preferable — to experience-rate auto drivers in some states. We wouldn’t do that in health care.

Another difference in the health care market is the externalities. People are afraid that if somebody coughs they will get the flu. Those are public health externalities. Another kind is financial externalities. If somebody gets lung cancer and needs a lung transplant, that is typically done at public expense. If people are disabled because of their smoking, they get Social Security disability insurance and that is shared by everyone. Then we have the “bleeding heart” externality. The fact that I care that a poor person has adequate consumption is something that will not be solved by markets.

Also on the list of differences is the “public good” aspect of biomedical research. Much of the improvement in health is due to this research, yet a private market will never provide all of it. We have relied on patents to provide an incentive, but they are imperfect solutions. They grant monopoly power to a seller, so the quantity supplied is lower and the price is higher than it would otherwise be.

RF: It seems as if there is a similar problem with providing incentives for vaccine production.

Sloan: Vaccines are a case in point. The general impression that many experts have, which I think is correct, is that vaccines are undervalued. Some of the greatest health benefits have come from vaccines. During my lifetime, we no longer talk about getting polio, so we don’t have to

develop interventions or improvements to the iron lung because we can actually prevent the disease.

RF: Some people have suggested that the government get more involved in the vaccine market as a purchaser.

Sloan: The government already is very involved in being a buyer of childhood vaccines. The problem is that it has such market power that the vaccine price is too low and not enough of an incentive to entice new suppliers. As government agencies get lower and lower prices for vaccines, manufacturers want to leave the business.

The question is how to structure incentives for entry. One suggestion is to pay vaccine manufacturers the social value of their products. That sounds like a good idea, but you are essentially giving economic rents to the manufacturers. This would be socially objectionable on distributional grounds. Another way to do it is for the government to have in its head what the value of a vaccine is, then negotiate with the manufacturers to get the best price that it can, recognizing that the price will need to increase in order to get sufficient supply.

RF: Another hotly debated topic in health care lately is whether to allow the reimportation of prescription drugs. What are your views on that issue?

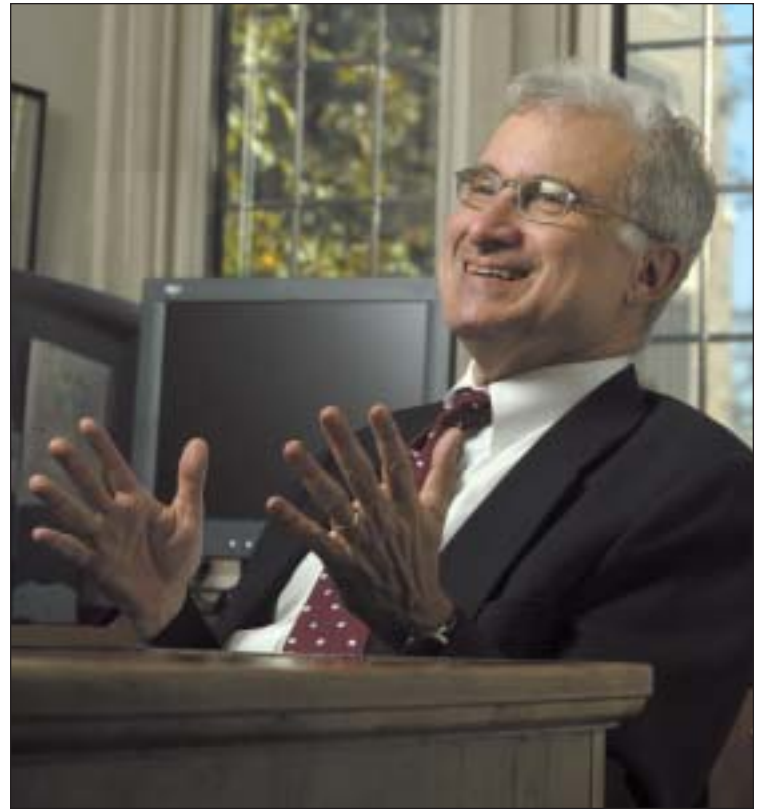
Sloan: The United States is a major importer of many goods. In fact, in trying to resolve the recent flu vaccine shortage, the federal government was willing to work with other countries to import vaccine. The policy concern about importing drugs is mainly motivated by attempts to satisfy the interests of pharmaceutical manufacturers.

Having said this, drug importation is not a solution to the rising cost of prescription drugs. Lower prices abroad reflect the regulatory policies in other countries. If we want to import drugs subject to price caps in other countries, it would be more efficient to impose caps in this country.

According to the concept of comparative advantage, the United States should produce goods and services for which it has an advantage and import goods and services for which it is at a disadvantage. Importing drugs manufactured in our country does not represent comparative advantage.

RF: There has been a lot of discussion about the price of medical care in general. Costs have outpaced overall inflation by a large margin for some time. Why do you think they are so high?

Sloan: First of all, I'm not sure that's the right measure. Yes, costs have been increasing. But can we say that the benefits of improved health are worth it? The health of the population is clearly improving. Mortality is substantially



reduced. There is some evidence that, at least, the elderly are less disabled than they used to be. They are living longer but not living worse. It's clear that if you did a report card on the benefits of improved health for the elderly — we've done it for four diseases — the benefits have grown more than the costs. That is, Medicare spending has grown less than the value of the benefits.

“Theoretically, managed care is a great idea. In practice, it is not so good.”

RF: For a while, we tried to reduce medical costs using managed care and health maintenance organizations (HMOs). Now there is a backlash against that approach and people want more choices. What is your opinion?

Sloan: The concept is a good one: to provide incentives to keep people healthy. If we can take care of people while they are healthy, then maybe we will spend less when they are sick. Also, given that we have so much insurance, individuals and their doctors have an incentive to use service down to the point where the marginal benefit is zero, and that is way too much care. So theoretically, managed care is a great idea. In practice, it is not such a good idea.

First of all, what incentive does my health plan provider have to prevent illness in the future, when in fact I may not even be around? Some people change jobs, some people get married and drop coverage because their spouse has better coverage, etc. When the health benefit is way downstream, the impetus to control diabetes, to control weight, or to

PHOTOGRAPHY: LES TODD, DUKE UNIVERSITY

encourage people to stop smoking is greatly attenuated.

A second problem is that we were never able to get clinical findings in line with health plans. If we know that doing certain things for people with diabetes improves their health, we never implemented real incentives on a widespread basis to give patients and their doctors a reason to do those things. And protocols weren't refined enough. They were just blunt policies like, "You've got to see a general practitioner before you can go to a specialist." But the cardiologist may know more about preventing heart disease. The endocrinologist may know more about diabetes. So now, gatekeeping has been gutted.

A third problem is that managed care never got the doctors on their side. Some nurse at the other end was telling them how to practice medicine. So the doctors were able to say the quality of care was going down the tubes and they brought the issue into the legislative arena. Nearly every state in the country enacted some patient protection law. This had a chilling effect on the managed care industry. The industry preemptively loosened up.

RF: Is there a good way to refine the managed care approach, or should we go back to the drawing board?

Sloan: I think we need to reinvent it. We need to use evidence-based protocols. Often, these protocols are based on doctors getting together and saying, "I think having an annual physical is a good thing." We need evidence.

Evidence does not always lead you to spend less, however. That's what we had thought before with HMOs. But the big dilemma for the future is that the evidence may sometimes tell you to do the opposite. As our colonoscopies get better, we may do more of them. As we refine diagnostic imaging, we may do more.



RF: Many lawmakers have blamed rising health care costs on "frivolous lawsuits" for medical malpractice and "defensive medicine" to stave off those lawsuits. Based on your work and other economists' research, how much has this really contributed to cost increases?

Sloan: It has to be very small. First of all, premiums are 1 to 3 percent of health care expenditures. If you took all the costs of inputs to hospitals and physicians' practices, much more is spent on other parts. Labor is much more, yet we don't say we have a crisis in physician labor.

On the defensive medicine front, we have never developed an operational definition of what we mean by that. Presumably, defensive medicine would be care that yields a marginal benefit substantially lower than the cost.

If we look at Prostate-Specific Antigen testing for prostate cancer, for example, you could say every time we get a negative finding that test was a waste, but, obviously, it was not. Then the question is which follow-up biopsy does the benefit exceed cost and which does not. Well, this would require an in-depth study. It also depends on the risk preferences of the person who is being tested. Some people may have a need to know whether there is something growing inside them and would be willing, even in the absence of insurance, to pay.

We need to determine whether, in the absence of the distortions in the market, this person would have been willing to pay for this added diagnostic testing. It's clear that some people would, so we can't say that all biopsies are a waste. And if we said they were all a waste, we would eliminate them and throw the doctors out of business.

RF: You also have researched how the tort system, as well as government regulation and market forces, influences alcohol use. What have you found to be the best deterrents for driving under the influence?

Sloan: Incentives matter and disincentives matter. One of our interests has been how the insurance system affects accident rates. If you have a DUI offense on your record in this state, your premium goes up remarkably and that is quite a deterrent.

With "dram shop liability," the server is held liable if a patron leaves the bar under the influence of alcohol and the server did not take precautions to prevent that person from leaving, and that was the cause of an accident that led to a fatality or life-disabling injury. We found some evidence to suggest that dram shop liability is a deterrent. People at home just conk out and go to sleep. But with people that have to go from point A to point B, the bartender is relatively efficient at preventing that accident. He might take the keys away. He might refuse service. After some point, he may water down the drinks.

RF: There are some people who continue to drink too much or smoke cigarettes despite the deterrents and health risks. Do they understand the risks? Is there any difference in how smokers and drinkers process information?

Sloan: We should separate drinking and smoking. Some moderate drinking is presumably good for your health. It's drinking to excess that is a problem. We have these various externalities with somebody going out on the highway drunk and driving off the road. A lot of accidents involve a single car, but some of them don't. Smoking is different because it is clearly bad for your health and most of the damage is to the self and the immediate family. The external effects are very small.

Our most recent research has found that smokers seem to process information differently, in that certain health events were less important in their own predictions of how long they would live. But we are now looking at this in much greater detail. Are smokers more likely to be risk-takers? Are they less future oriented? Do they place less value on good health? We are finding that they are less future oriented and less risk averse than nonsmokers.

Another way that smokers differ is they seem to be more pessimistic about the future. If you ask them, "What is the probability that we will have double-digit inflation?" or "What is the probability that we will have another depression like in the 1930s?" they are more likely to fear these adverse consequences. These events don't relate to the individual's smoking behavior, but may indicate that they feel more at the mercy of external events, that they have less control over their lives.

RF: The United States is one of the few industrialized countries without a comprehensive national health care system. Without considering the merits of such a system, why do you think we remain unique in this respect?

Sloan: To understand why we do not have national health insurance as others do, one needs to investigate the historical context under which this system was adopted in other countries. For example, Germany adopted national health insurance over a century ago as part of Bismarck's industrialization policy. At the time, health care costs were much lower than they are presently and political opposition was weak. In England,

Frank Sloan

► Recent Positions

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► Previous Appointments

Vanderbilt University (1976-1993); University of Florida (1972-1976); University of California, Los Angeles (1970-1971); RAND Corporation (1968-1971)

► Education

B.A., Oberlin College (1964); Ph.D., Harvard University (1969)

► Selected Publications

Author or editor of numerous books on medical malpractice, the cost and quality of health care, and other public policy issues. Author or co-author of scholarly articles in such publications as the *Journal of Health Economics*; *New England Journal of Medicine*; *Journal of the American Medical Association*; *American Economic Review*; *RAND Journal of Economics*; and *American Journal of Public Health*.

national health insurance was adopted at an opportune time in the immediate post-World War II period.

Once implemented, it is politically impossible to take national health insurance away, like Social Security in the United States. To implement the program, one must overcome substantial political opposition from well-organized stakeholders. This has been difficult to do in this country. Perhaps it could have been done during the Johnson Administration when Medicare and Medicaid were implemented and the Democrats had won the White House by a wide margin and controlled both houses of Congress.

RF: Are there particular economists who have influenced your own work?

Sloan: I would say that it is a type of economist. When I was in graduate school, the best economists were incredibly broad. They would know foreign languages. They would know history. Milton Friedman, Kenneth Arrow, Paul Samuelson are a few economists that exemplify this ideal, as well as Wassily Leontief, who did input-output analysis.

Then I was influenced by younger economists. My main graduate school advisor was Martin Feldstein. He was only three years older than me but very engaged in policy. I would go in with my dissertation and, in 15 minutes, he would run through it all so thoroughly that I would spend the rest of the day digesting what I had learned.

Some people have criticized Marty on grounds that his models are not sufficiently deep or complicated. But he is very practical, and he relies on empirical evidence, not just on abstract theorizing. Also, Marty has devoted part of his career to public service. He has that broad kind of knowledge and understands political constraints. He isn't going to say that government is stupid and should stay out of the way. He has a lot of common sense.

I remember a professor who studied real-business cycles and gave a seminar, one of the last macro seminars I had attended. Somebody asked, "How does your model fit the recession of 1974?" He said, "I don't really study those things." That to me is unacceptable as an economist. I just don't know what he's accomplishing if he can't understand real-life phenomena and how to bring his tools to bear on what's going on. **RF**

Man and Machine

**THE NEW DIVISION OF LABOR:
HOW COMPUTERS ARE CREATING THE NEXT JOB MARKET**

BY FRANK LEVY AND RICHARD J. MURNANE
PRINCETON, N.J.: PRINCETON UNIVERSITY PRESS, 2004, 200 PAGES

REVIEWED BY JOHN A. WEINBERG

Among the many famous maxims that have come down to us from the work of Adam Smith is: “The division of labor is determined by the extent of the market.” This statement captures an evolution frequently observed in the nature of businesses and jobs as economies and markets grow. In a small market, particularly in a preindustrial economy, goods were produced and sold in small shops. All stages of production were carried out by the same artisans, the most senior of whom may also have been the shop’s owner.

The growth associated with industrialization brought production on a much larger scale. And with that growth in scale came processes that allowed production to be broken into distinct pieces performed by distinct workers. So one effect of industrialization was the shift in the distribution of work away from artisans who were skilled at and performed an array of related tasks, to workers who specialized in performing one, often relatively simple part of the production process.

These changes originated with the introduction of technology that allowed large-scale production to take place. That is, there has long been an interdependency between the size of demand for goods (the extent of the market) and technology in determining the evolving nature of work.

In *The New Division of Labor*, Frank Levy and Richard Murnane, economists at the Massachusetts Institute of Technology and Harvard University, respectively, direct their attention to the contemporary version of this interdependence. Their particular focus is on the ways in which computers have changed the workplace. Since the dawn of the computer age, many observers have predicted widespread replacement of machines for human work.

Levy and Murnane assess the extent to which such predictions have come true and, more importantly, attempt to

dig deeper into the relationship between information technology and human work. On the first score, it seems clear that some early fears about massive displacement of workers by computers were widely off the mark. Still, it also seems clear that the effect of technology on work has differed widely for workers of varying skill levels and occupations. It is this variation that claims the authors’ attention.

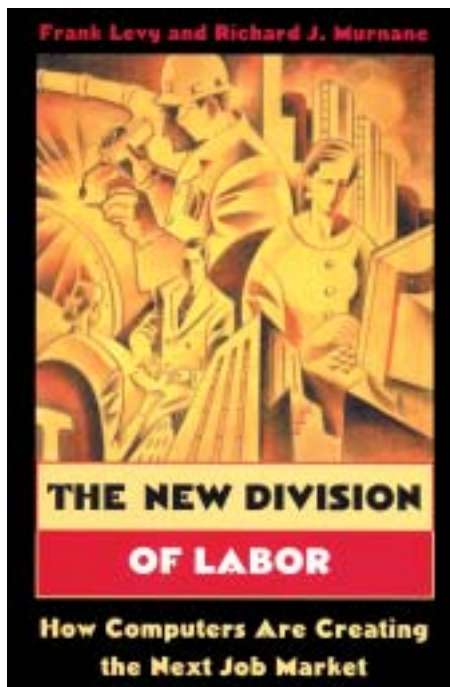
The (Limited) Power of Computers

The authors emphasize jobs in two broad categories — blue collar and clerical — which accounted for over half the U.S. workforce in 1970 but for less than 40 percent today. The increased mechanization of manufacturing and the resulting declines in blue-collar jobs are by now old stories. But the decline in the clerical category also has been striking. Many clerical jobs involve the organization, storing, and retrieving of information. These are tasks that computers handle particularly well, and so the demand for clerical labor has fallen.

The authors give a number of examples of other jobs in which computers’ comparative advantage has reduced the relative demand for human input. And not all of these are clerical or mid-level jobs. Some, like the job of a trader in the pits at the London International Financial Futures and Option Exchange, were quite highly paid. The exchange replaced its trading pits with an electronic trade execution network in 1999. While the information processing tasks

associated with trading were perhaps more complex than traditional clerical work, it was still the case that computers could do that processing — searching for matches between buyers and sellers — more efficiently.

All decisionmaking, and therefore most jobs, involves information processing of some kind. But computers are not better than humans at every kind of information processing. Levy and Murnane draw some useful distinctions. They single out decisions that require “rules-based logic” as those that can be easily delegated to machines. Of course, rules-based logic is simply the raw material of computer programming. A problem is broken down into a sequence of statements, the truth or falsehood of which can be unambiguously assessed. Many decisions involve



using data provided as inputs to perform such a sequence of tests, culminating in a final decision. The authors give mortgage underwriting as an example of a problem that, at first blush, seems quite complex but that is still well suited to automation.

The power of computers to solve even complex problems has at times led people to hold out high hopes for “artificially intelligent” computers that could perform any decisionmaking task more efficiently than mere humans. In such a vision, there is no limit to the ability of machines to replace work done by people. Levy and Murnane take a distinctly different view. They identify an array of decisionmaking problems where rules-based logic is not the basic building block. A key component of this other category of problems is what they call “pattern recognition,” by which they mean the ability to assess a situation and determine if it fits a previously encountered pattern. Through examples, they show that “situations” can be very complex things. Consider a driver assessing and reacting to traffic conditions, or a prison guard surveying interaction among prisoners and watching for signs of trouble.

Building on pattern recognition, the authors describe skills and jobs that computers cannot easily replace. “Expert thinking” involves a body of knowledge and experience necessary for specialized pattern recognition. In the work of automobile mechanics, computer diagnostics can identify many problems encountered by car owners, but this technological tool doesn’t always provide the answer to the customer’s problem. When it doesn’t, the expert mechanic needs to draw on his experience of similar cases to efficiently search for a solution. Many jobs also require “complex communication” — the ability to convey and understand nuances and subtle differences in meaning between statements that may sound very similar. In face-to-face or telephone communication, this skill may involve reading meaning into voice tone or body language. In many businesses, a human customer-service function remains superior to menu-driven, automated alternatives.

New Skills for a New Age

Ultimately, Levy and Murnane are most interested in how businesses train and how schools teach in a world where rules-based logic allows machines to perform many tasks and where expert thinking and complex communication are the uniquely human skills that keep people employed. On the training side, they describe cases of large businesses, like IBM, that make substantial investments in training their workers. They argue, however, that profit-seeking businesses will in general not provide enough in the development of expert thinking and complex communication skills. These are general skills that make workers equally valuable to competitors as to the firm that provides the skills. So, naturally, firms are reluctant to invest in the acquisition of such skills because workers can easily take them to a new company. Instead the authors look to the education system, and in particular to standards-based

educational reforms, as a source of improved skill-building for the U.S. workforce.

Standards-based educational reforms mean different things to different people, and Levy and Murnane argue that not all standards are created equal. They are much less interested in standards related to particular content areas than in standards that assess a student’s success in developing the types of thinking and communication skills necessary to do the jobs at which humans still have a comparative advantage. And these types of skills don’t lend themselves as easily to simple, multiple-choice testing. They describe a program undertaken by a Boston public elementary school that has had some considerable success. This example makes clear that the kinds of reforms the authors have in mind are not simple or cheap. They involve a great deal of direct student-teacher interaction, as well as guided interaction among students.

In the end, the picture Levy and Murnane paint of the future of the U.S. labor market is not too promising. They foresee a continuation of recent trends, involving replacement of low-skilled work by technology and a widening gap in earnings between the skilled and unskilled. Given the divisive politics of public education, it’s hard to imagine sweeping changes in primary and secondary education taking place very rapidly.

But many of the authors’ examples show that not all jobs involving expert thinking and complex communication require a college degree. That is, not all such jobs are “high-skilled” in the conventional sense of the term. Indeed, general economic trends could ultimately lead to increases in the demand for jobs that do not require higher education but do involve the types of skills the authors emphasize — for instance, jobs that involve face-to-face (or voice-to-voice) customer contact.

The New Division of Labor gives a concise description of just what it means, in the computer age, to say that jobs are being lost to machines. Computer technology is different in this regard from earlier technological advances. Since computers are likely to continue to be a source of new innovations, it may be natural to assume that the labor market trends brought about by the information revolution are likely to continue. But innovations are just that — they’re new developments that aren’t anticipated before they appear. This makes projection of trends into the future a risky business. Rather than hoping for a change in the direction of technology, the authors prefer to argue for adapting our approach to education to the currently prevailing technological trends. That’s a hard preference with which to argue. **RF**

EDITOR’S NOTE

Our review of Too Big to Fail: The Hazards of Bank Bailouts by Gary Stern and Ron Feldman, which appeared in the Fall 2004 issue of Region Focus, stated that the book’s authors failed to address the problems a coinsurance program may face if the Federal Reserve lends liberally from the Discount Window. Actually, Stern and Feldman discuss that issue on pp. 157-158 of their book.

District Economic Developments

BY ROBERT LACY

The Fifth District economy continued to expand at a solid pace in the third quarter of 2004. Payroll employment growth was large enough to finally nudge Fifth District employment above the peak reached prior to the 2001 recession. And while retail sales were sluggish, output of goods and services overall was nicely higher.

Economic growth in Fifth District states was relatively strong in the third quarter of 2004. The broad services sector expanded at a brisk pace, despite softness in retail sales, and manufacturing maintained good momentum through the summer. Personal income and employment moved higher as well, while the District's unemployment rate edged lower. By late fall, economic growth had slowed somewhat, but the District's economic expansion remained firmly intact.

Services Sector Expands but Retail Soft

The Fifth District's services sector expanded at a solid pace during the third quarter. Continuing gains in employment and personal income helped stoke demand for most District services businesses, boosting their revenues during the period.

Retail sales, however, remained a weak spot. District retailers told us that higher energy prices were partly to blame for lackluster third-quarter sales. Discount chains reported particularly soft sales as higher gasoline prices strained the already-tight budgets of lower-income customers. And by late fall, an increasing number of retailers were expressing concern that a sharp rise in heating bills might constrain spending even further this winter.

District Manufacturing Expands

District manufacturers recorded substantially higher output in the third quarter. Our indexes of shipments and capacity utilization rose throughout the period. And despite hefty price increases for some raw materials — most notably oil, steel, copper, and lumber — final goods prices rose only moderately.

Manufacturing activity began to slow in the fourth quarter. However, District manufacturers generally remained optimistic about future sales prospects, and a number of them announced plans to expand production facilities in 2005. Dell's plans to build a computer manufacturing facility in the Triad area of North Carolina was cheered in an area of the state staggered by job layoffs in the textiles industry. The new plant is expected to open in the fall of 2005 and eventually employ 1,500 people.

But the manufacturing news from Maryland was not as upbeat. In November, General Motors announced it would close its Broening Avenue assembly plant in Baltimore in 2005. Approximately 1,100 jobs are expected to be lost. Built in 1935 and in its heyday employing more than 7,000 people, the plant was a mainstay of Baltimore's once considerable manufacturing economy.

A Jobs Recovery

Employment in the District continued to expand in the third quarter. While the pace of growth was slower than in the second quarter, year-over-year growth in employment was a respectable 1.8 percent. With the third-quarter growth, payroll employment in the District finally exceeded the prerecessionary peak reached in December 2000.

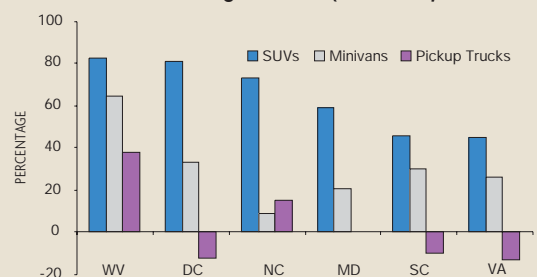
State Economic Indexes Up

The Federal Reserve Bank of Philadelphia now publishes indexes of economic performance for all 50 states. Its coincident indexes are measures of overall economic performance and are based on payroll employment, unemployment rates, average hours worked in manufacturing, and real wage and salary disbursements. These indexes suggest that economic activity rose in all District states in the third quarter but was strongest in North Carolina and West Virginia.

Did You Know . . .

You may be a truck driver and not even know it. Most sport-utility vehicles (SUVs) and minivans are classified as light trucks by the U.S. Department of Transportation because they are built on truck chassis or have truck-like features. If you are one of those SUV "truck" drivers you have lots of company these days. According to the Census Bureau's 2002 survey of the nation's trucks, in Fifth District states there was about one SUV for every 12 people.

**SUVs, Minivans & Pickup Trucks
Growth in Registrations (1997-2002)**



Nonfarm Employment Third Quarter 2004

	Employment (Thousands)	% Change (Year Ago)
DC	672	1.6
MD	2,535	2.1
NC	3,863	1.2
SC	1,835	1.3
VA	3,591	2.5
WV	736	1.3
5th District	13,232	1.8
US	131,521	1.3

Unemployment Rate (Percent)

	3rd Qtr. 2004	3rd Qtr. 2003
DC	7.8	7.0
MD	4.2	4.5
NC	5.0	6.5
SC	6.4	7.0
VA	3.5	4.2
WV	5.3	6.2
5th District	4.7	5.5
US	5.5	6.1

Personal Income Third Quarter 2004

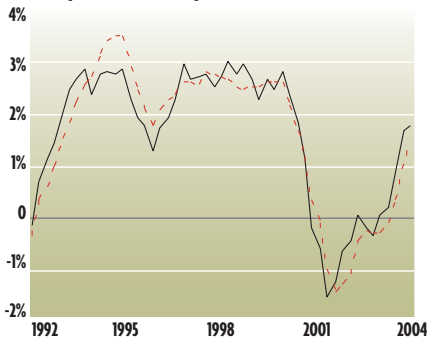
	Income (\$ billions)	% Change (Year Ago)
DC	28.3	5.6
MD	218.6	5.5
NC	251.2	5.1
SC	114.3	5.2
VA	264.7	6.1
WV	47.3	5.7
5th District	924.4	5.5
US	9,670.6	5.2

———— Fifth District

- - - - - United States

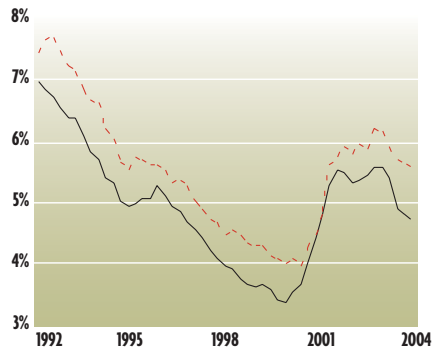
Nonfarm Employment

Change From Prior Year
First Quarter 1992 - Third Quarter 2004



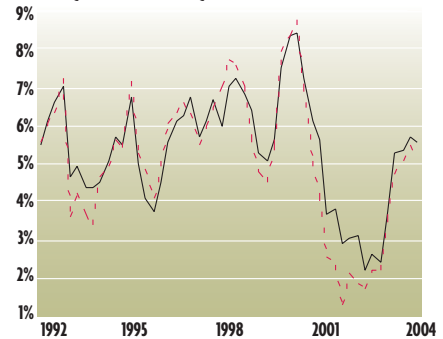
Unemployment Rate

First Quarter 1992 - Third Quarter 2004



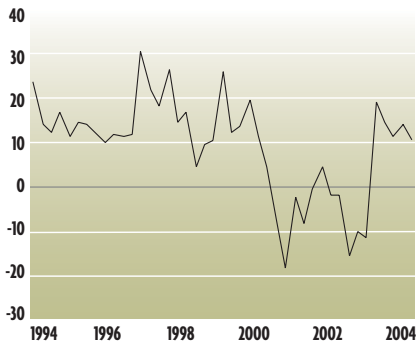
Personal Income

Change From Prior Year
First Quarter 1992 - Third Quarter 2004



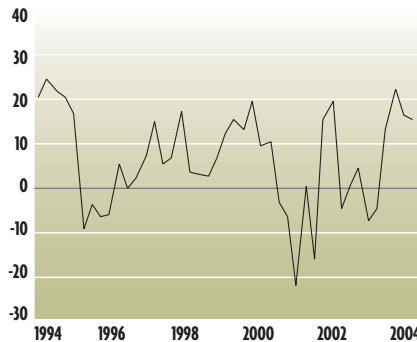
FRB—Richmond Services Revenues Index

First Quarter 1994 - Third Quarter 2004



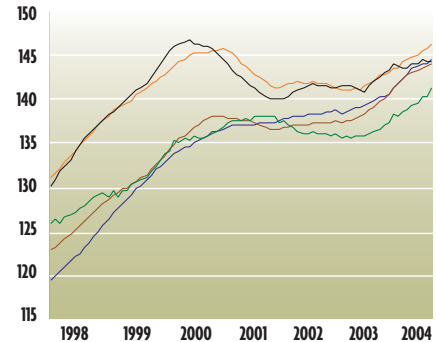
FRB—Richmond Manufacturing Shipments Index

First Quarter 1994 - Third Quarter 2004



Coincident Economic Activity Index

(July 1992=100)



NOTES:

- 1) All data series are seasonally adjusted.
- 2) FRB-Richmond survey indexes are diffusion indexes. Positive numbers represent expansion, negative numbers contraction.
- 3) State nonfarm employment estimates are based on surveys of establishments. These employment figures differ from those used to calculate state unemployment rates.

SOURCES:

Income: Bureau of Economic Analysis, U.S. Department of Commerce, <http://www.bea.doc.gov>
 Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>
 Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>
 Coincident economic activity index: Federal Reserve Bank of Philadelphia, <http://www.philadelphiafed.org>

For more information, contact Robert Lacy at 804-697-8703 or e-mail Robert.Lacy@rich.frb.org.



District of Columbia

BY ANDREA HOLLAND

Among Fifth District jurisdictions, economic activity during the current recovery has been relatively weak in the District of Columbia. The labor market and household and business financial conditions remain subdued, and performance of the residential real estate market continues to lag activity districtwide.

Since the end of the 2001 recession, District of Columbia job numbers have expanded 2.3 percent, the third strongest growth rate districtwide. Measures of payroll employment in the District of Columbia, however, mostly reflect increases in commuters from Maryland and Virginia into the city, rather than resident job growth.

Because commuters cloud the job growth numbers, an alternative indicator of labor market conditions is initial unemployment insurance claim statistics. This measure shows that initial claims have dropped only 15.4 percent during the recovery — a relatively shallow decline compared to the Fifth District decline of 45.8 percent, suggesting a comparatively weaker labor market picture.

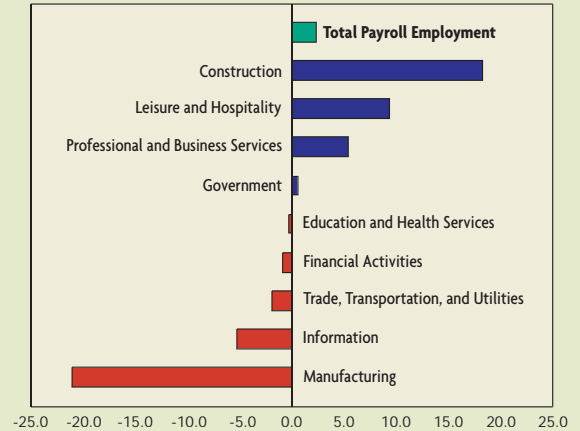
With fewer residents holding jobs, measures of personal income in the District of Columbia have also stagnated since the start of the recovery. Incomes have grown only 3.8 percent since late 2001, the slowest rate among Fifth District jurisdictions.

Not all economic news was bad for District of Columbia households, though. Personal bankruptcies have declined 22.4 percent — the largest drop among Fifth District jurisdictions.

Adding to this good news, business bankruptcies in D.C. have also fallen the most districtwide — easing 52.2 percent during the recovery period. In contrast, venture capital investment has lessened. Compared to late 2001, capital inflows stand 65.7 percent lower.

Switching gears, D.C.'s residential real estate market has continued to move ahead during the recovery, but not at the breakneck pace as seen in other district states. Building permits have risen steadily by 7 percent — the second smallest growth rate in the Fifth District. Existing home sales activity posted a 16.9 percent growth rate during the same time period but trailed districtwide growth of 42.3 percent.

Payroll Employment Growth



4th Quarter 2001 - 3rd Quarter 2004
Percent Change in Payroll Employment by Industry Sector

SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

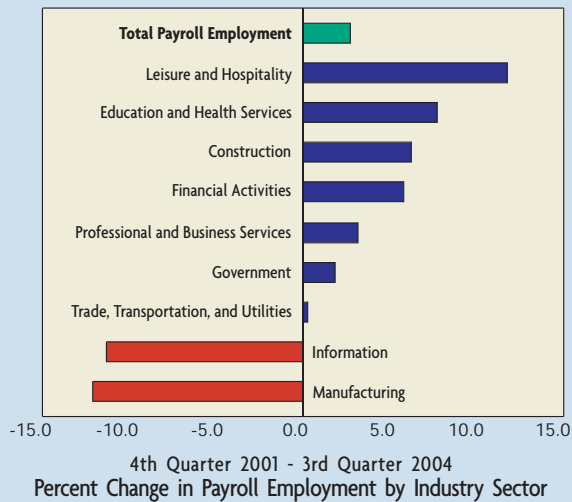
	Percent Change at Annual Rate From		
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Nonfarm Employment	672.0	1.0	1.6
Manufacturing, NSA	2.6	0.0	-1.3
Professional/Business Services	145.8	3.6	3.1
Government	232.1	2.3	0.9
Civilian Labor Force	301.2	0.6	-0.4
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Unemployment Rate	7.8	7.3	7.0
Building Permits, NSA	335	760	182
Home Sales	15.2	179	16.1

NOTES:

Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Government, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®



Payroll Employment Growth



SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

Three years into the recovery, the latest data suggest that Maryland's economy has rebounded quickest among Fifth District states. Nearly all indicators of the labor market and financial conditions have posted strong growth.

According to the Bureau of Labor Statistics, business hiring in Maryland has been robust over the current recovery. Payrolls in the state have expanded 2.7 percent since late 2001, the second strongest growth rate districtwide. By sector, leisure and hospitality payrolls have rebounded the most, while manufacturing and information job performance has been the weakest, still showing a net loss.

Tracking the aggregate pickup in hiring, initial unemployment insurance claims have fallen 37.9 percent during the recovery, exceeding the decline nationwide. Also positive, personal bankruptcy filings have declined 21 percent, marking the second largest drop districtwide.

Personal income is also a beneficial gauge of growth. Over the course of the recovery, income growth has expanded 7.4 percent in Maryland, ranking highest among district states and coming in well above the national growth rate of 4.8 percent. By industry, earnings expanded the most in management of companies and enterprises, and real estate and rental and leasing.

Real estate markets continue to boom in the state. Existing home sales in Maryland currently total 30.2 percent more than at the beginning of the recovery. Likewise, the number of new building permits issued has expanded, though not as fast as in other district states.

Outside of the real estate market, bankruptcy data suggest broad improvement at other business establishments. The number of business bankruptcies has fallen 36.5 percent lower over the course of the recovery. On a less positive note, however, the only measure not to improve in Maryland — or in any other district state for that matter — was venture capital activity, where inflows have declined by about one-third.

	Percent Change at Annual Rate From		
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Nonfarm Employment	2,535.4	2.7	2.1
Manufacturing, NSA	144.4	-2.6	-0.7
Professional/Business Services	374.0	2.1	3.9
Government	466.0	4.0	0.3
Civilian Labor Force	2,952.6	0.6	1.6
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Unemployment Rate	4.2	3.9	4.5
Building Permits, NSA	7,435	7,636	6,602
Home Sales	154.1	146.0	143.8

NOTES:
 Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
 Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
 Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
 Government, thousands of jobs, SA; BLS/Haver Analytics
 Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
 Unemployment Rate, percent, SA; BLS/Haver Analytics
 Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics
 Home Sales, thousands of units, SA; National Association of Realtors®



North Carolina

BY ANDREA HOLLAND

North Carolina businesses have enjoyed broad gains during the current recovery period, but a rebound in labor market and household financial conditions has yet to fully materialize.

Growth in nonfarm payrolls at North Carolina establishments (0.3 percent) has matched West Virginia's during the course of this recovery — posting the weakest growth rates in the Fifth District. By sector, education and health services have posted the strongest gains, while goods-producing sectors such as manufacturing, and natural resources and mining recorded negative job growth.

More positively, initial unemployment insurance claims in North Carolina — a measure of future labor market activity — have decreased 48.9 percent since the end of the last recession, the largest decline in the Fifth District.

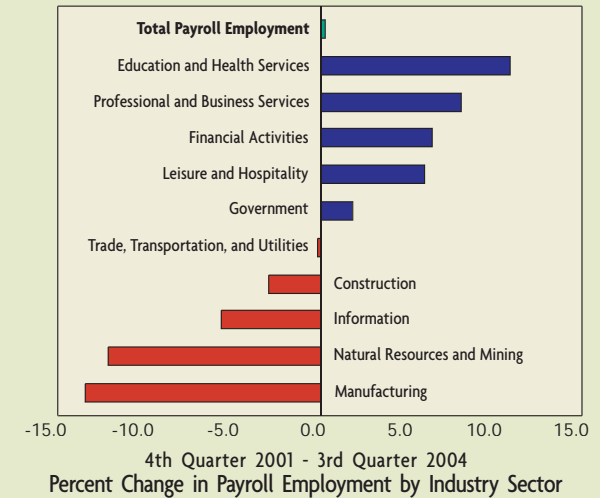
Slow job growth has weighed on North Carolina households in the last few years. Personal income growth has been weaker than in all but one other district jurisdiction since the end of the last recession, recording only a 4.7 percent gain. Earnings have also expanded modestly, with weakness persisting in construction, retail trade, and transportation and warehousing.

Weak income growth is likely a reason personal bankruptcies have risen; new filings stand 5.2 percent higher than at the end of the recession — marking the second slowest recovery rate districtwide.

Indicators of the financial health of North Carolina firms were more encouraging. Business bankruptcies have declined 37.9 percent over the recovery, the second strongest contraction districtwide. And venture capital inflows into North Carolina stand only 19.3 percent lower than at the beginning of the recovery — the second smallest decrease among district jurisdictions.

Conditions in real estate markets were also positive. The number of third-quarter building permits exceeded the number authorized in the last quarter of the 2001 recession by 32.6 percent. In addition, existing home sales in North Carolina have expanded 52.9 percent, the strongest increase districtwide.

Payroll Employment Growth



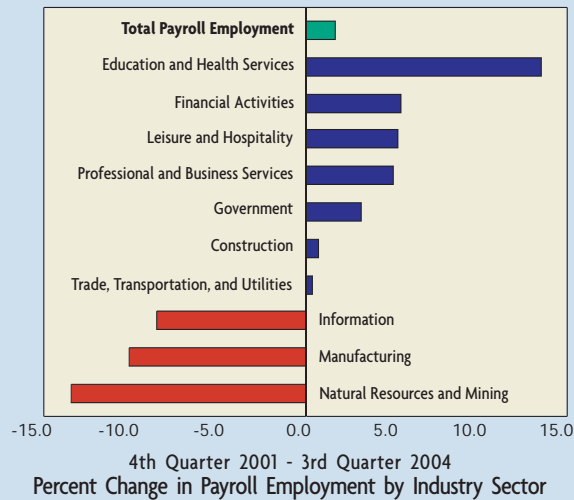
SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

	Percent Change at Annual Rate From		
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Nonfarm Employment	3,862.5	2.3	1.2
Manufacturing, NSA	582.2	-0.8	-2.4
Professional/Business Services	443.9	2.4	4.3
Government	654.6	-0.1	0.8
Civilian Labor Force	4,178.2	-2.1	-1.7
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Unemployment Rate	5.0	5.4	6.5
Building Permits, NSA	24,137	24,664	20,761
Home Sales	361.7	337.4	307.9

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Government, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®



Payroll Employment Growth



SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

An economic upturn appears to be taking hold in South Carolina, but the state has yet to regain footing lost during the last recession. The most recent information suggests that employment activity and household and business conditions in South Carolina remain short of their peak, though growth in the residential real estate market remains robust.

South Carolina payrolls have picked up by 1.7 percent during the current recovery – slightly below the districtwide average of 1.8 percent. By sector, education and health services, and financial activities have bounced back the most, while growth in manufacturing, and natural resources and mining jobs remains in negative territory.

The sluggish job market recovery is reflected in South Carolina's initial unemployment insurance claims. Although claim submittals have declined since the start of the recovery, the rate of decline has been slightly slower in South Carolina than it has been districtwide.

Despite lackluster job growth, earnings have risen in almost all industry sectors since the end of the recession – including manufacturing – boosting total personal income in the state. Personal income has expanded 5.6 percent in South Carolina since the fourth quarter of 2001, outpacing the nationwide gain of 4.8 percent.

Notwithstanding solid income growth, personal bankruptcy filings have risen 2.3 percent higher during the recovery period.

Business bankruptcies have also continued to climb during the expansion – filings in South Carolina have risen 17.1 percent higher, the biggest gain districtwide. In other business news, venture capital investment into South Carolina has been spotty during the recovery, posting two quarters of flat inflows.

But not all news was glum on the business front. Turning to real estate, new building permits have continued to climb during the recovery, with South Carolina recording the second largest expansion districtwide. Likewise, existing home sales continue to set records, coming in 45.9 percent above the fourth quarter of the 2001 level.

	Percent Change at Annual Rate From		
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Nonfarm Employment	1,834.9	-0.2	1.3
Manufacturing, NSA	270.4	-1.1	-1.5
Professional/Business Services	192.6	1.5	1.5
Government	334.6	5.1	1.7
Civilian Labor Force	2,072.6	3.4	3.1
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Unemployment Rate	6.4	6.5	7.0
Building Permits, NSA	10,821	11,249	9,703
Home Sales	165.5	165.5	153.6

NOTES:
 Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
 Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
 Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
 Government, thousands of jobs, SA; BLS/Haver Analytics
 Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
 Unemployment Rate, percent, SA; BLS/Haver Analytics
 Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics
 Home Sales, thousands of units, SA; National Association of Realtors®



Virginia

BY ANDREA HOLLAND

Virginia's economy has rebounded sharply since the end of the 2001 recession. The employment situation and financial conditions of Virginia households have improved markedly and the real estate market continues to forge ahead. Financial conditions have brightened at Virginia firms as well, though gains have been less pronounced.

Since the end of the recession, Virginia firms have boosted payrolls by 2.9 percent, the best recovery among district states. Also positive, third-quarter unemployment insurance claims were about half the amount recorded in the last quarter of the recession, marking the second best pickup districtwide.

Employment gains over the recovery period have been centered in the construction and financial activities sectors, reflecting a booming real estate market. Existing home sales have expanded 36.3 percent and new building permits have risen 38.2 percent since the end of the 2001 recession.

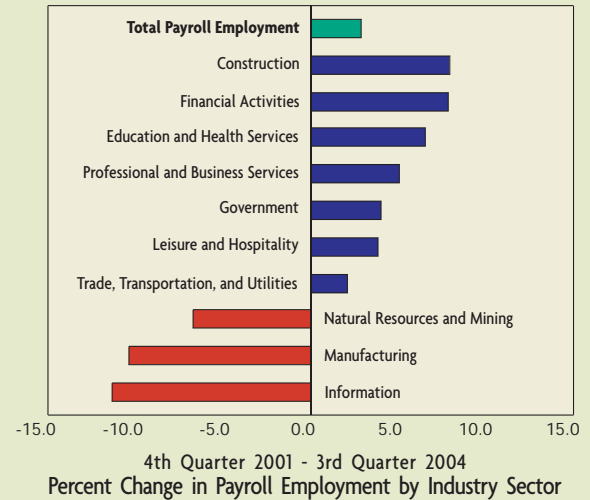
Strong job creation has boosted earnings in Virginia households. Personal income has grown 6.8 percent since the end of the 2001 recession, the second fastest districtwide. Earnings expanded the most in construction, management of companies and enterprises, and real estate and rental and leasing — again reflecting continued strength in residential real estate.

Higher earnings have also limited personal bankruptcies in Virginia — third-quarter filings are 5.6 percent lower than at the start of the recovery, marking the third largest drop districtwide.

The positive news from the household side is slowly making its way to Virginia businesses. Business bankruptcy filings have moderated since the last quarter of 2001, though only by a modest 1.5 percent, the second weakest decline districtwide.

In contrast to all this good news, Virginia continues to experience weak venture capital inflows, recording the most pronounced contraction among district states.

Payroll Employment Growth



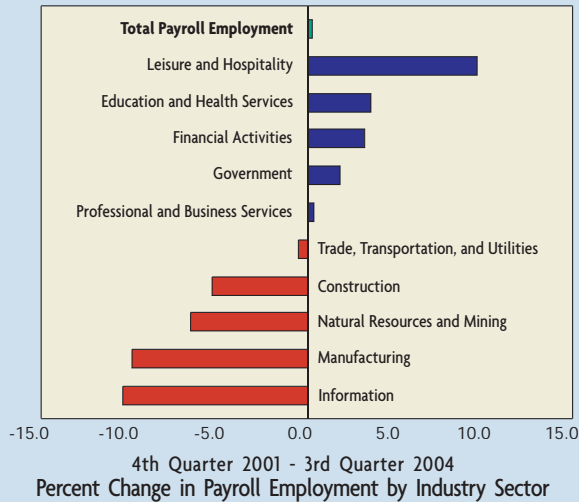
SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

	Percent Change at Annual Rate From		
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Nonfarm Employment	3,591.0	1.0	2.5
Manufacturing, NSA	295.4	-2.6	-2.4
Professional/Business Services	581.0	4.7	5.8
Government	654.0	4.0	2.3
Civilian Labor Force	3,842.1	-0.2	1.6
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Unemployment Rate	3.5	3.5	4.2
Building Permits, NSA	16,125	17,237	14,230
Home Sales	203.2	200.4	185.8

NOTES:
 Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
 Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
 Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
 Government, thousands of jobs, SA; BLS/Haver Analytics
 Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
 Unemployment Rate, percent, SA; BLS/Haver Analytics
 Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics
 Home Sales, thousands of units, SA; National Association of Realtors®



Payroll Employment Growth



SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

	Percent Change at Annual Rate From		
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Nonfarm Employment	736.4	5.2	1.3
Manufacturing, NSA	63.4	-3.5	-1.6
Professional/Business Services	57.0	0.7	1.7
Government	144.0	9.4	1.3
Civilian Labor Force	802.7	2.9	1.9
	3rd Qtr 2004	2nd Qtr 2004	3rd Qtr 2003
Unemployment Rate	5.3	5.2	6.2
Building Permits, NSA	1,466	1,544	1,291
Home Sales	37.6	31.6	31.9

NOTES:
 Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
 Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
 Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
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 Home Sales, thousands of units, SA; National Association of Realtors®

For more information regarding state summaries, call 804-697-8273 or e-mail Andrea.Holland@rich.frb.org.

Recent economic data suggest that West Virginia's economy has expanded slowly during the current recovery. Indicators of employment activity and household and business financial conditions have yet to perk up, though real estate activity was positive across the board.

Payroll employment has risen only 0.3 percent in West Virginia during the current recovery, tying North Carolina for the weakest growth districtwide. Some sectors have posted solid gains — leisure and hospitality, and education and health services — but the jobs performance remains weak in the information and manufacturing sectors.

Lackluster job growth shows through to the state's unemployment insurance statistics. Although third-quarter initial claims numbered 32.5 percent fewer than claims at the start of the recovery, the rate of improvement in West Virginia remains well below both the national and district average.

With sluggish job growth, income measures have also been slow to improve in the state. Personal income has expanded only 5.5 percent over the course of the recovery. Earnings rose modestly in most industries, but declines were recorded in transportation and warehousing, mining, utilities, construction, and information. Unfortunately, the modest gain in earnings did not pull down the rate of personal bankruptcy filings, which stand 28.3 percent higher than in late 2001.

On the flip side, the number of business bankruptcy filings have decreased 27.9 percent during the recovery — exceeding the national decline. But other indicators of business activity are less encouraging. Venture capital investment remains generally stagnant in West Virginia — inflows over the current recovery would be best characterized as spotty.

Real estate activity continues to forge ahead though. Existing home sales have grown 33.3 percent since the start of the recovery period. Also positive, housing permits have expanded at a breakneck pace in West Virginia, posting the strongest growth rate districtwide.

The Broken Window Fallacy

BY AARON STEELMAN

Florida was ravaged by four major hurricanes in 2004. According to the Insurance Information Institute, victims of the storms filed more than \$22 billion in insurance claims. That exceeds the amount of payouts following 1992's massive Hurricane Andrew and is roughly two-thirds the \$32 billion in claims resulting from the terrorist attacks of Sept. 11, 2001.

The hurricanes that hit the Sunshine State were clearly a tremendous personal disaster, killing dozens and displacing thousands more from their homes. But they were also a major financial setback, right? Not according to some reporters and analysts.

In September, *USA Today* ran a story headlined "Economic Growth from Hurricanes Could Outweigh Costs." Among the people interviewed for the story was Steve Cochrane, managing director at Economy.com. "It's a perverse thing ... there's real pain," he said. "But from an economic point of view it's a plus."

The places destroyed by the storms will need to be rebuilt, Cochrane noted. And according to some estimates, this will mean 20,000 new construction jobs, not to mention large expenditures on building materials and telecommunications equipment.

What this ignores, though, is how those resources would have been spent otherwise. Sure, a lot of money will go toward the rebuilding effort. But the key word here is "rebuilding." The construction workers in Florida are not putting up new buildings. They are simply replacing those that have been destroyed. No new net wealth is being created. In fact, as the insurance claims make clear, more than \$22 billion was *lost* because of the storms.

In the absence of the storms, that money could have gone toward any number of productive uses. But instead it will be spent to return Florida to its pre-hurricane condition.

To illustrate this point, consider the following two scenarios. First, \$22 billion is spent on college scholarships for gifted but poor students in Florida and other parts of the Southeast. That money will fund their educations, enabling them to acquire better-paying jobs than they would have otherwise. And some may even go on to start their businesses. Second, \$22 billion is spent rebuilding houses, hospitals, and retail centers that were destroyed by the storms, while in the meantime people live at shelters or with family members, forgo medical care or seek it at more distant facilities, and shop at less favored stores.

Which scenario seems more desirable? Most would say that scenario No. 1 is clearly preferable. But those who argue that the hurricanes are good for Florida's economy would lead you to believe that scenario No. 2 is just as good if not better.

How could they believe something so seemingly unreasonable? Perhaps these people are concerned about income distribution, and believe that the hurricanes will have egalitarian effects. After all, much of the property destroyed belonged to relatively wealthy people, while many of the rebuilding jobs will go to lower- and middle-income people.

Another explanation is that they have fallen prey to what the 19th century French economist Frederic Bastiat called the "broken window fallacy." In one of his most widely cited essays, Bastiat asks the reader to consider the example of a fictional character named James Goodfellow.

Goodfellow has a rambunctious son, who one day breaks a window in the family's house. The repairman who replaces the window will be made better off, but how about Goodfellow and society as a whole?

If Goodfellow "had not had a windowpane to replace, he would have replaced, for example, his worn-out shoes or added another book to his library," writes Bastiat. In short, the money that was spent repairing the window could have been spent in another, more productive way.

Not only that: Society, in general, does not benefit from the broken window and its subsequent repair. "To break, to destroy, to dissipate is

not to encourage national employment," writes Bastiat. More to the point, "Destruction is not profitable."

When analyzing the economic effects of a certain action or event, Bastiat reminds us that it is important to pay attention to both "what is seen" and "what is not seen." In the case of Goodfellow, what is seen is the money being spent to repair the window. What is not seen is how that money would have been spent otherwise. Similarly, in the case of Florida, it's easy to see the billions of dollars going toward reconstruction efforts, but more difficult to see how those resources could have been put toward more useful ends.

This second step — considering what is not seen — often eludes many observers and leads them to spurious conclusions that upon closer inspection are obviously wrong. When you hear someone argue that destruction is good for the economy — and you almost certainly will the next time a natural disaster strikes — remember the case of the broken window. It's a simple example, but one that yields important insights. **RF**

"Those who argue that hurricanes are good for Florida's economy have fallen prey to the broken window fallacy."

Affordable Housing

House prices have been rising for several years. That has been great for homeowners. But how have non-homeowners, especially lower- and middle-income people, been affected by this trend? Is there a lack of affordable housing in the Fifth District — and if so, what is causing the shortage and what can be done about it?

Underground Economy

When people think about the underground economy, drugs and prostitution often come to mind. But the underground economy is much larger than these illicit activities. When you pay a handyman to fix a leaky sink or a neighborhood kid to mow your lawn, and that income goes unreported, those transactions become part of the underground economy. How large is the underground economy in the region? And is it necessarily a bad thing?

Falling Dollar

The dollar has been falling against other currencies for several months. It's no surprise that this is affecting Fifth District business — but how depends on whom you ask. We'll survey a number of sectors, from manufacturing to agriculture to tourism, to find out what the falling dollar means to them.

Sticky Prices

The prices of some goods, such as gasoline, change almost daily. Others, like newspapers, remain constant for years. The latter is an example of the phenomenon known to economists as “sticky prices.” Models that account for sticky prices are important in formulating monetary policy. We'll review the research in this area with a focus on the work of Richmond Fed economist Alexander Wolman.

Interview

A conversation with economist Thomas Schelling of the University of Maryland. A past president of the American Economic Association, Schelling's research has spanned a number of areas, including conflict and bargaining theory, racial segregation, military strategy, and climate change.

Economic History

The furniture industry has been a large part of North Carolina's economy for more than a century. But how and why did it develop there? A look at the history of this important industry.

Jargon Alert

Many people think of the economy as a “zero-sum game” — one person wins and the other one loses. But most economic transactions are actually positive sum games. We'll explain why.

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Highlighting Business Activity in the Fifth District

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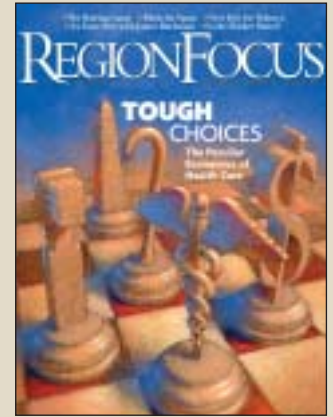
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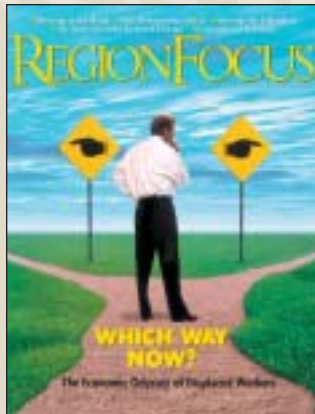
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