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No Guarantees

Professors in this country have long enjoyed certain features of campus life: leafy strolls through the college grounds, a spirit of community and open debate, and, of course, tenure. But lately even the job security traditionally associated with faculty membership is being reconsidered. Tenure, like so many other benefits American workers used to expect, is no longer a given part of the employee-employer pact.

In this issue of *Region Focus*, we examine the labor market in higher education. Universities increasingly are hiring faculty members on a part-time or adjunct basis. Tenure-track jobs are in shorter supply. At first glance, it might appear that cost-conscious university administrations are driving this trend. But another narrative is that there is a new breed of faculty candidates who don't consider tenure particularly important. They might favor work on a contract basis. While tenure has its appeal, some candidates are more than willing to trade it for job mobility and the flexibility that comes with it.

What's clear is that the amount of time people typically spend in one position or with one organization is becoming shorter across all sectors of the U.S. economy, not just in higher education. This trend has important implications for the broader labor market — for example, the fact that general skills have grown more important than job-specific skills. It is likely no coincidence that in this more dynamic labor market, the role of retirement benefits is evolving as well.

Retirement benefits still make up a large share of how much employers spend on their workers' total benefit packages, just not as large as in the past. In 1960, pension and other benefits accounted for almost 60 percent of total benefit spending, compared with closer to 46 percent today. The new wrinkle is in how benefits are structured. Health benefits, for example, require greater attention from employees in terms of selecting insurance coverage.

But nowhere is the shift to employee-accountable benefits more evident than in the retirement realm. There has been a nearly wholesale move away from so-called "defined benefit" pension plans to "defined contribution" plans. Defined benefit pensions guarantee a post-retirement income stream for life, with little or no oversight by employees. Defined contribution plans, usually in the form of 401(k)s, oblige workers to make choices affecting their financial futures, with employees bearing all of the investment risk.

Consider these figures: More than half of all full-time employees have some sort of pension coverage, a percentage that has declined a little over time but not much. During the same period, pensions of the defined benefit variety have dropped from 69 percent to less than 40 percent among full-time employees with pensions. Today, 80 percent of all full-time employees covered by pensions have defined contribution plans.

One of the leading reasons why this trend is taking place has to do with the changes I have described in the U.S. workplace. The ultimate value of a defined benefit pension depends on a combination of the worker's length of employment and highest wage. As a result, these traditional pension plans reward employees who stay with their employers.

The decline in defined benefit plans has coincided with the decline in job tenure. For men, expected job tenure fell 18 percent between 1983 and 2001. While employers have moved away from defined benefit pensions in part because of their high costs, they also have done so because employees no longer value them as highly. In today's dynamic labor market, employees increasingly prefer portable retirement plans.

It looks as if 401(k) plans will be not only the retirement plan of the present, but also of the future. Of course, these plans carry the risk that employees' retirement years won't be adequately funded. Indeed, many studies have shown that some workers aren't setting aside enough in their 401(k) plans, and often falling short of maximizing the impact of their employer matches. About one in five eligible employees fails even to sign up for their firms' 401(k) plans. Those who do are responsible for making investment choices in their portfolios, a chore that previously was handled by professional managers. Fewer employers now bear the investment risk associated with their employees' pensions.

While these changes can be viewed positively since they give workers greater control over their retirement options and greater flexibility to change jobs, they require an increased level of financial awareness. Innovations like automatic enrollment in 401(k) plans are helping. But with life expectancies rising and the well-publicized troubles facing Social Security, the future well-being of our citizens depends more than ever on their financial savvy.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND

A Great Crisis, A Long Debate

BY VANESSA SUMO

Throughout the decades of discussion on the causes of the Great Depression, this remarkable event is the standard against which economic theory and policy are put to the test

The Great Depression is the enduring symbol of what an economic catastrophe looks like: a stock market crash, bank runs, closed down factories, abandoned farms, soup and bread lines, and families moving from one town to another in desperate search of work. It was a tragic event that devastated the lives of many around the world, and yet fascinating to those who seek to fully grasp what went wrong. To this day, an economic debate rages over what caused and prolonged the Great Depression. "To understand the Great Depression is the Holy Grail of macroeconomics," wrote Fed Chairman Ben Bernanke in his book *Essays on the Great Depression*.

Before the Depression, brisk economic growth had characterized most of the "Roaring '20s." It was a time of great prosperity, despite the two mild recessions that occurred during that decade following the sharp downturn in 1921. Large enterprises emerged that benefited from the latest mass production technologies. New roads, telephone lines, power plants and other public infrastructure were constructed, which in turn increased people's appetite for cars, refrigerators, and other durable goods. The introduction of installment credit likewise spurred households' consumption. But this period of plenty was put to an abrupt halt when the stock market crashed in October 1929.

Soup kitchens were probably the only places where the hungry and unemployed could get a meal during the Great Depression.

PHOTOGRAPHY: NATIONAL ARCHIVES 306-NT-165.319C

Many view Wall Street's Black Tuesday as the start of the Great Depression. In his book, *The Great Crash 1929*, economist John Kenneth Galbraith argued that the bullish market of the 1920s had created a "bubble," or a situation where stocks trade at prices much higher than can be reasonably explained given a company's expected future earnings. However, there continues to be a debate about whether the stock market was indeed overvalued. Economist Irving Fisher, who wrote *The Stock Market Crash and After* a year after the crisis, thought that the "market went up principally because of sound, justified expectations of earnings, and only partly because of unreasoning and unintelligent mania for buying." In the last 20 years, post-Depression economists have laid out their arguments on either side.

Nevertheless, many public officials, including those at the Fed, probably believed that a speculative bubble was driving the stock market boom, and thus tried to squeeze the flow of money into the system in order to prick that bubble. "There should be no doubt that the United States adopted a policy of tight money at the beginning of 1928, nor should there be much dispute as to what motivated this policy," wrote economist James Hamilton of the University of California at San Diego. Hamilton says that despite repeated assertions by the Fed that it did not see itself as an arbiter of security prices, most of those who have studied Fed policy during this period agree that it followed contractionary measures to curb the stock market boom.

With the pressure applied and investor confidence waning, the stock market crashed. While the crash and the Depression are two distinct events in the eyes of economists, the former

was arguably responsible for the sharp reduction in consumption and investment that ensued. Household budgets took a hit, but that loss was probably not such a large share of their total wealth. Nonetheless, Black Tuesday warned of a gloomy economic outlook, enough to discourage households from spending on durable goods and housing. Firms would hold back or postpone investments for the same reason. "It changed the atmosphere within which businessmen and others were making their plans, and spread uncertainty where dazzling hopes of a new era had prevailed," wrote economists Milton Friedman and Anna Schwartz in their classic *A Monetary History of the United States.*

To make matters worse, a wave of banking panics gripped the country just a year later. So severe was the crisis that by the end of 1933, only about half the number of banks that existed in 1929 were still standing. The panics culminated when President Franklin Roosevelt declared a national "bank holiday" in March 1933. Roosevelt ordered all banks to close, allowing them to reopen only after government inspectors declared them solvent.

Bernanke says that bank failures were not uncommon during this time, largely due to regulatory restrictions on branch banking that resulted in many small, independent banks. "In this sort of environment, a significant number of failures was to be expected and probably even desirable," he wrote. For instance, rural banks closed when farmers who borrowed heavily couldn't pay their debts following a precipitous decline in farm commodity prices.

However, the banking crises of this period differed "both in magnitude and the degree of danger posed by the phenomenon of runs." The absence of deposit insurance and the fact that banks had relied heavily on very liquid deposits which could be withdrawn at any time resulted in a panic that affected not just banks that were on the margin but almost the entire system. Indeed, starting with the agricultural areas that experienced the most severe bank failures, "a contagion of fear spread among depositors ... But such contagion knows no geographical limits," wrote Friedman and Schwartz. (There is a debate about how much actual contagion there actually was. Some people say that it's hard to find evidence of healthy banks taken down by runs.)

Why did the stock market crash and bank failures lead to a long period of slump that, at its peak, forced one in four of working Americans out of a job? Economists have been trying for decades to fit long-held views as well as shape new ones to explain the depth and protracted decline in economic activity during the interwar period. Bernanke thinks that we do not have our hands on the Grail yet, but substantial strides have been made in furthering that quest for answers.

The Liquidationists and Keynes

"Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate," said Andrew Mellon, President Herbert Hoover's Treasury secretary during the Depression. "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people," Mellon said.

This was the prevailing sentiment among policymakers and economists at that time — that the Great Depression was the result of excesses that needed to be "washed out," as it were. And the best way to achieve this was to do nothing; that is, to watch idly as firms and factories went bankrupt. Perhaps this was an extreme view, but one which finds support in two well-established schools of thought.

Say's law, based on the early 19th century work of Jean Baptiste Say, convinced classical economists that "supply creates its own demand," such that it would only be a matter of time before wages and prices adjusted to let demand mop up that excess supply. Moreover, the economists of the Austrian school argued that the Depression was the result of an overinvestment in capital goods, fueled by an expansion in credit and monetary policy that was too loose during the 1920s. "The inflation [of the money supply] was clearly precipitated deliberately by the Federal Reserve," wrote Murray Rothbard, a prominent economist of the Austrian school. The abundance of credit, and the low interest rate that accompanied it, led businessmen to make investment decisions that perhaps would not have been made under "normal" conditions, that is, if the Fed had not intervened.

Eventually, the inflationary bubble would have to pop, and those investments would begin to unravel. "The 'boom,' then, is actually a period of wasteful misinvestment," wrote Rothbard. The only way to cure the Depression would be to let it run its course. "The Depression, then, far from being an evil scourge, is the necessary and beneficial return of the economy to normal after the distortions imposed by the boom," argued Rothbard. Moreover, trying to ease the economic malaise with more policy intervention would not only delay the resolution but also magnify the pain. For instance, pursuing expansionary monetary and fiscal policies would only exacerbate this imbalance and prevent labor and capital from being redistributed to more productive uses.

But as the Depression wore on, this view of the world became steadily unpopular, for it did it not seem to adequately explain why the economy was languishing for so long. Was there really nothing that could be done? British economist John Maynard Keynes assured that there could be, postulating that wages and prices do not adjust quickly but rather very sluggishly, so that the economy can fall out of equilibrium for a very long time. This miserable slump was not due to an excess in production capacity, but rather to a shortfall in demand. Hence the government can step in to revive demand and take the economy out of the Depression.

The Great Money Contraction

The series of severe banking panics from 1930-1933 was a crucial moment in the Great Depression, for the impact of bank failures would reach much further than bank shareholders and depositors simply losing their money. It would, as Friedman and Schwartz painstakingly analyzed, lead to such a drastic decline in money supply that they called this phenomenon the "great contraction."

The spate of panics and runs that ensued made people incredibly distrustful of banks, as they worried that banks were no longer safe. Indeed, people felt more secure holding on to their money at home, perhaps even hiding it under a mattress. Also, in anticipation of bank runs, and probably to convince depositors that they had ample money in the vault, banks increased their reserves.

People holding on to more currency and banks keeping more reserves, relative to deposits, had the perilous effect of pulling down the "money multiplier." The amount of money available to keep the economy running depends on the ability of banks to turn deposits into loans a multiple number of times. But if people keep more of their money at home and banks decide to increase the amount sitting in their vault, instead of putting them to work as deposits, then this process is impeded. The result, as Friedman and Schwartz find, is that the money supply plunged by over a third between 1929 and 1933.

Could anything have been done to stem this dangerous decline? Friedman and Schwartz place the blame squarely on the shoulders of the Federal Reserve. "At all times throughout the 1929-1933 contraction, alternative policies were available to the System by which it could have kept the stock of money from failing, and indeed could have increased it at almost any desired rate," Friedman and Schwartz wrote.

At the height of the wave of banking panics, the Federal Reserve could have aggressively loaned money to banks or suspended the convertibility of deposits into currency, similar to the resolution of the 1907-1908 banking crises. However, the Fed did not yet exist in that earlier episode, so a group of private banks took the lead in lending money and refusing to convert deposits into currency. (The Treasury also assisted by making money available to the troubled banks.) But with the Federal Reserve System in place, these banks probably deemed such a concerted move unnecessary. After all, it was the Fed's responsibility to orchestrate a solution, as would be expected of a "lender of last resort." Thus, the Great Depression was arguably as bad as it was because of policy failures at the Fed.

But critics of Friedman and Schwartz's view, led by economists Peter Temin of the Massachusetts Institute of Technology and Barry Eichengreen of the University of California at Berkeley, think that the fall in money supply was beyond the Fed's control. Under the gold standard, the United States had to keep a constant rate of exchange between the dollar and gold. As gold flowed out of the country, the Fed had no choice but to correspondingly contract the supply of money in order to maintain the peg.

Other countries on the gold standard faced a similar trade-off between expanding their money supply and stimulating their economies in times of hardship, and their commitment to keeping the value of their currencies aligned with the rest of world. Indeed, many studies have shown that the sooner a country abandoned the gold standard, the more quickly that country, including the United States, recovered from the Depression. (In 1944, a modified form of the gold standard was agreed upon that would fix a country's currency exchange rate to the dollar. In turn, the dollar would peg its value to gold. This monetary arrangement, commonly known as the Bretton Woods system, ended in 1971.)

Deflation and Credit Channel

While there is much support for Friedman and Schwartz's monetary view of the Great Depression, Bernanke argues that the contraction in money supply cannot fully explain why the banking crisis would lead to such a protracted decline in output in the 1930s. While monetary shocks are important, he thinks that credit shocks help explain the link between the financial sector and the lengthy duration of the output decline.

Bernanke finds inspiration in Fisher who argues that deflation and its impact on the real value of debt is an important ingredient in understanding the great depressions. If debt forces households and firms into bankruptcies and the health of bank balance sheets to deteriorate, then banks will likely move away from providing loans and put their money in safer assets. At the same time, many borrowers will begin looking like riskier bets, because the value of their assets (or the collateral attached to the loan) relative to their debt has sharply eroded with deflation. Hence, borrowers, particularly smaller ones, will find it very difficult to obtain bank credit in bad times. Even if they do find it elsewhere, credit will likely be available only at a substantially higher price than what they could otherwise have obtained with banks. Presumably, banks have the most expertise with respect to screening and monitoring borrowers and thus have the lowest cost of intermediating credit.

Various accounts of the credit conditions at the time of the Great Depression portray the effect of the banking crisis on the supply of credit. Bernanke points to one made by the National Industrial Conference Board in 1932: "During 1930, the shrinkage of commercial loans no more than reflected business recession. During 1931 and the first half of 1932 (the period studied), it unquestionably represented pressure by banks on customers for repayment of loans and refusal by banks to grant new loans." Others observed that groups that relied heavily on bank loans – households, farmers, unincorporated business, and small corporations — were most affected. Moreover, the contraction of bank credit in the United States was twice as large as

those of other countries, even when compared to those with similar output declines.

Bernanke argues that these credit effects do a good job of explaining the protracted nature of the decline in output. His view implies that the way to get out of the Depression is to establish new or revive old channels of credit and rehabilitate insolvent debtors, which could be a very long and slow process. A story on why the economy was slow to recover based on the importance of monetary shocks alone, in contrast, depends on the slow diffusion of information or unexplained stickiness of wages and prices. Indeed, Bernanke says that although the financial system did not improve immediately after a government-directed financial rehabilitation program was put in place, it could be argued that this was "the only major New Deal program that successfully promoted economic recovery."

An Explanation in Equilibrium

Friedman and Schwartz's money view and Bernanke's credit view generally rely on interruptions to the normal functioning of the market, such as sticky wages and prices, or limits to borrowing. However, there is an alternative story to the Great Depression that does not rely on such frictions. In this view of the world, markets function very well, such that the trade-offs which households and firms face when making optimal decisions on how much to save, consume, and work, determine economic activity, and change in response to certain shocks. Typically "real" shocks are held responsible for the peaks and troughs of the business cycle.

How can this "real business cycle" approach explain the Great Depression? Its proponents have focused their attention mostly on explaining why the recovery took so long. As economists Harold Cole and Lee Ohanian of the University of California at Los Angeles assert, "The weak recovery is puzzling because the large negative shocks that some economists believed caused the 1929-1933 downturn — including monetary shocks, productivity shocks, and banking shocks — become positive after 1933. These positive shocks should have fostered a rapid recovery." By some measures, the economy had not significantly recovered even by 1939.

Cole and Ohanian suspect that the Roosevelt's New Deal cartelization policies go a long way in explaining the protracted character of the slump. Roosevelt believed that the severity of the Depression was due to excessive competition that led to lower wages and prices and consequently to lower demand and employment. To remedy this, the National Industrial Recovery Act (NIRA) permitted collusion in some sectors, but only if wages were raised immediately and collective bargaining with labor unions was permitted. Even after the courts struck down the NIRA, the government ignored collusive arrangements for as long as those industries paid high wages. The government then passed the National Labor Relations Act, which gave more bargaining powers to workers than under the NIRA.

But these measures did not bring about the outcomes that Roosevelt had imagined. Instead, these policies significantly raised wages and prices and restricted employment, thus prolonging the pain of the Depression. Though others have pointed to the ills of the New Deal cartelization policies before, Cole and Ohanian present a model which finds that the cartelization policies explain 60 percent of the slow recovery.

So why is there no consensus about the explanation of the Great Depression more than six decades since it ended? This may seem surprising, but it probably reflects the wider debates among macroeconomists — which are still very lively — about the origins of business cycles. With no consensus about the "small" fluctuations, it is perhaps no surprise that the "Holy Grail" of macroeconomics is still beyond reach. But the Great Depression has always prompted economists to think about the origins of cycles. **RF**

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JARGON ALERT

Comparative Advantage

BY ERNIE SICILIANO

A man decides to open a bakery. He figures that for each hour he bakes, he can make 20 doughnuts, which he will then sell for $2 each. Or he can make 10 loaves of bread that sell for $3 each every hour.

The first week he is in business he bakes both doughnuts and bread and finds demand is so high he cannot possibly do both. He decides to hire an assistant. As an entrepreneur, the baker has limited capital and so he hires a local high school student to help out. Because the youth has limited baking experience, he can make only 15 doughnuts or five loaves an hour. The baker realizes he should specialize in either doughnuts or bread, but because he is clearly adept at producing both, he is not sure which task to pick.

The baker would be wise to heed the advice of David Ricardo, who first theorized about comparative advantage in the early 1800s. The baker, Ricardo would say, ought to specialize in bread making because that would be cheaper.

Most often, comparative advantage is used when discussing trade between nations. A country holds a comparative advantage when it can produce a good at a lower opportunity cost than another country.

Comparative advantage differs from absolute advantage, which is the ability of a country to produce a good more efficiently. While it is possible for a country to lack an absolute advantage in producing goods, every country has a comparative advantage.

For example, imagine if the United States and Mexico both produced tacos and hot dogs. To produce each taco, the United States needs two workers while Mexico needs three. For every hot dog produced, the United States needs one worker while Mexico needs two. The United States holds an absolute advantage in producing both tacos and hot dogs because it can produce both goods with fewer workers. However, Mexico holds a comparative advantage in producing tacos, because it can produce them at a lower opportunity cost. In the United States, every taco made costs two workers, and thus two hot dogs. For Mexico, every taco made costs three workers, and only one and a half hot dogs.

Comparative advantage is important in the macroeconomy because it explains the benefits of global trade. If each country specialized in the good for which it held a comparative advantage and then traded among each other, more goods would be produced and the efficiency of the global economy would be maximized.

In the Mexico-United States example, if Mexico produced one extra taco, the United States could produce two extra hot dogs. In the global economy, there would be the same number of tacos and one more hot dog, indicating a slightly higher standard of living for both countries, assuming they could trade freely.

Comparative advantage is also useful in analyses of firms and industries. With no specialization, it would be reasonable to assume that both the baker and his assistant spend four hours on both bread and doughnuts. If that were the case, the bakery would produce 140 doughnuts and 60 loaves of bread. At that level of production, there would be $460 in revenues.

Not bad, but if the baker spent all his time on bread while his assistant focused on doughnuts, then the bakery would produce 80 loaves of bread and 120 doughnuts — increasing production in both bread and doughnuts. Assuming demand exists for the excess production, the bakery will now have revenues of $480 dollars. That's also better, by the way, than the $440 the bakery could earn if the owner specialized in doughnuts.

Looking at comparative advantage enables one to understand how scarce resources are used in the microeconomy. Often, the most talented individuals in our society are adept at more than one task. For example, the baker was superior in both bread-baking and doughnut-making. However, his time was limited to eight hours a day, and therefore a scarce resource. To get the most production in such a small time frame, the baker had to maximize productivity to increase revenue. In the end, the consumer ultimately benefits because the increased number of doughnuts and bread represents a rise in the standard of living, if not an increase in waistlines. **RF**

ILLUSTRATION: TIMOTHY COOK

Buying Time

BY CHARLES GERENA

Pundits and politicians often complain about out-of-control health care costs. Why are we spending more and more money on the latest high-tech devices, medical procedures, and wonder drugs, they ask, when we could be using that money to make the economy more productive and competitive?

The reason, according to two economists, is that we *are* getting something for all of the money we're spending on health care. As Americans have become wealthier overall, we have chosen to devote more of our resources to leading longer, healthier lives. In essence, we're buying ourselves more time.

In their recently published paper, Robert Hall of Stanford University and Charles Jones of the University of California at Berkeley build upon a large body of work on the value of life and the willingness to pay to avoid death. They note that several studies have shown that increases in longevity have been roughly as important to welfare as increases in consumption for things unrelated to health care. One study used a model in which health investments reduced the "depreciation rate" of the knowledge capital acquired through schooling.

"The Value of Life and the Rise in Health Spending" by Robert E. Hall and Charles I. Jones. *Quarterly Journal of Economics*, February 2007, vol. 122, no. 1, pp. 39-72.

Hall and Jones developed their own model to describe how the nation divides its resources between health and nonhealth spending to maximize social welfare. Using mortality rate and health expenditure data, the model projects that health care services will account for roughly one-third of the United States' gross domestic product by the middle of the 21st century. That would be double the share of GDP devoted to health care in 2000 (15.4 percent) and six times the share in 1950 (5.2 percent).

Their model is based on the economic tenet of standard preferences: Consumers make rational choices in order to maximize their expected utility, or level of satisfaction. The more you consume of something, typically, the less additional utility you obtain from the additional consumption. Drinking a glass of lemonade to cool off on a hot summer day gives you more pleasure than drinking the fifth glass that makes you rush to the bathroom.

In the case of health care services, the diminishing returns are offset by the increased value of living longer. Therefore, as overall incomes rise and people are willing and able to purchase more of certain goods and services, they shift their spending from other areas of consumption to health care.

In general, consumers earning more income seek out the next most desirable alternative that they can afford. They demand fewer inferior goods (like beer and apartments) and demand more normal goods (like wine and single-family housing). For some normal goods, demand rises at a faster rate than the change in incomes. These are called "superior goods." Hall and Jones place health care in this final category.

While Hall and Jones say that people are willing to spend more on health care to improve their lives, the case is not quite closed. There is still a debate over whether these additional expenditures have actually made us healthier. Some studies have found that marginal increases in health care expenditures yield only low marginal increases in outcomes, though certain preventative measures like flu vaccines and breast cancer screening have had a major impact on public health. Advances in medical technology, changes in behavior, greater awareness through health education, and declines in pollution may deserve some of the credit for our longer life spans.

Technological advances have also been blamed for pushing up the cost of health care. Hall and Jones acknowledge that the invention of new and more expensive diagnostic equipment, surgical tools, and medications has contributed to higher health spending. But it isn't the whole story. "Expensive health technologies do not need to be used just because they are invented," the economists wrote in their paper published in the *Quarterly Journal of Economics*.

This brings up another problem for higher health care costs — the third-party payer system, which puts government and employer-funded health insurance between those who buy medical services and those who sell them. Most economists would agree that the system interferes with the usual interaction between the price of goods and the amount of goods demanded.

Hall and Jones focused on investigating what the optimal level of health care spending should be, regardless of what kind of payer-system is in place. Their conclusion is that deeper economic forces are at work to drive up health care spending globally: "Although distortions in health insurance in the United States might result in overuse of expensive new technologies, health shares of GDP have risen in virtually every advanced country in the world, despite wide variation in systems for allocating health care." **RF**

SUMMERTIME SUPPLY AND DEMAND

Foreign Students Fill Beach Jobs During the High Season

This is the second summer in a row that Agata Korzeniewska has worked at Food Lion Store No. 2503, located at milepost 14.5 in Nags Head, N.C. Korzeniewska, 22, is from Warsaw, Poland, an economics major with three years left until graduation.

Her countrymen abound in this Outer Banks beach town, where the high season unemployment rate is about 2.5 percent and able bodies like hers are crucial to satisfying the consumption habits of tourists. Not only are the Polish students abundant, but also Russians, Thais, Bulgarians, and Turkmen, among other nationalities, pedaling their cruiser bicycles up and down the Croatan Highway.

"I want to learn English," says Korzeniewska, whose English is already near perfect. "It's a good program for students."

Korzeniewska is referring to the J-1 visa program and the international firms that pair students with U.S. jobs, plus collect a fee for the service. In general, firms that recruit, interview, and place international students don't assist in many other logistics, such as housing and transportation, nor does Food Lion. In 2006, the State Department issued about 128,000 visas for summer travel nationwide, with 2,488 for work in North Carolina. This summer Food Lion employed about 500 international students in 32 stores along the East Coast, from Ocean City, Md., to Myrtle Beach, S.C. Without them, it's easy to imagine tourist season business grinding to a halt — or at least, firms having to dramatically raise both wages and prices in order to attract qualified laborers.

Agata Korzeniewska pauses while at work in a Nags Head Food Lion, a summer job she obtained through the J-1 visa program.

Rick Chance is manager of the Food Lion in South Nags Head. The store has an easy-to-use, online application system that it once hoped would solve its summertime problem of filling jobs, but it hasn't lived up to expectations. The system collects no more than two applications a month, Chance says. Most U.S. college students like to work in bars or clubs, he says, making it difficult to find capable workers to stock groceries, retrieve carts, and cash out shoppers. About half the store's summertime staff consists of foreign students. "With the huge business in the summer, we have to go outside," Chance says. "These kids are really great. They're eager to do a good job."

As an economics major, Korzeniewska understands the basic need for foreign workers like herself, and she is glad for the opportunity. Here, she earns $8.75 an hour, at least $3 more than she would likely earn in Poland, she says. After her 8 a.m. to 4 p.m. shift concludes, she bikes across the street to the Sonic drive-in for her second job.

Korzeniewska lives with 16 other students in a five-bedroom house in Kill Devil Hills. But it's not so bad, she says. And she gets two days off a week to hang out on the beach. With her savings, she expects to head to Florida at the end of the summer. By the end of September, her visa expires and she heads home to Warsaw. — DOUG CAMPBELL

STORM SEASON

South Carolina Law Expands Coastal Coverage

Insuring the coast is risky business and growing riskier. Coastal insurance has been either hard to come by or expensive since the storm season of 2005. The demand for payouts post-Hurricane Katrina stretched insurance firms to the limit, and that's created more demand for reinsurance, leading to price increases all the way around. According to the National Association of Insurance Commissioners, firms lost 4 cents for every $1 in premium collected between 1985 and 2005 in South Carolina. That includes just over $3.7 billion in losses (in 2005 dollars) from Hurricane Hugo, which clobbered the coast in 1989.

Two weeks into the 2007 hurricane season, with forecasts calling for a 50 percent chance of a big storm on the East Coast, the state Legislature passed a coastal insurance bill. Among other provisions, the law expanded the territory covered by the S.C. Wind and Hail Underwriting Association, a state pool backed by insurance firms. The pool sells wind insurance when homeowners can't get it anywhere else, at above-market rates. (The National Flood Insurance Program insures properties in flood-prone areas.) The new law also allows tax-free catastrophe savings accounts for policyholders to pay deductibles, and provides

PHOTOGRAPHY: DOUG CAMPBELL

tax credits for homeowners who make storm-resistant improvements, such as hurricane-proof siding.

Property insurance rates there have risen between 20 percent and 100 percent since 2005. Even though South Carolina did not take a storm hit in 2005, carriers revisit risk models and update rate structures after blockbuster storms like Katrina. Reports of condominium insurance hikes as high as 700 percent grabbed everybody's attention. The nearly one-quarter of South Carolinians who live in the seven counties that lie along the state's 187 miles of coastline have reason for concern. Residential and commercial property there is insured to the tune of about $150 billion and it's growing.

The major piece of the law includes the tax incentives the state is offering to insurance firms to encourage them to write policies along the coast. The details are still being worked out, but one provision credits firms for policies on properties previously eligible for coverage only through the state wind pool.

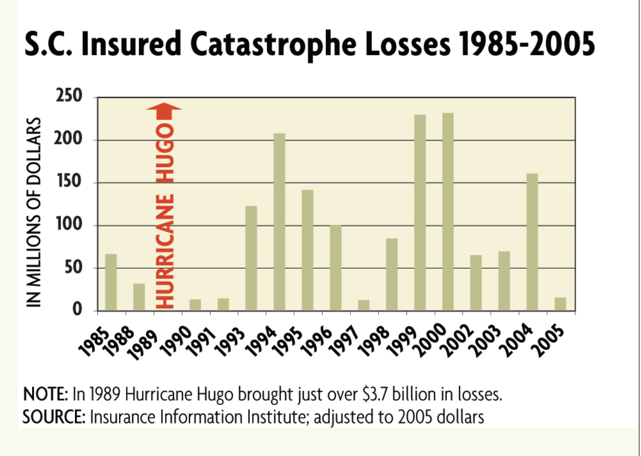
Economist Don Schunk of Coastal Carolina University says that tweaking market incentives works better than heavy-handed regulation. "What we're seeing in South Carolina has been a fairly good model," he says. "We don't know how everything is going to play out over the next few years, but to offer incentives to encourage companies to write policies, to get the homeowner to hurricane-proof their homes, we [economists] tend to like that kind of activity." He noted that premiums began to stabilize and new carriers entered the market even before the legislation passed because the industry had observed the bill's progress.

While the South Carolina legislation may mitigate availability and affordability of insurance in risky areas, the fundamental problem remains: Rates have been underpriced, and that's contributed to overdevelopment on the coastlines. Between changing weather patterns and the population shift toward the U.S. coasts, catastrophes seem unavoidable. Paying for them is likely to become even more of a problem.

A catastrophe by its nature is unexpected and expensive, and is defined by the industry as an event that reaches $25 million or more in claims. Economists Kip Viscusi of Vanderbilt University and Patricia Born of California State University at Northridge used a large data set on homeowner's insurance coverage between 1984 to 2004 that documented the effect of blockbuster catastrophes on firms. The results were published in a National Bureau of Economic Research working paper in 2006.

In short, they found that a catastrophe reduces total premiums earned and the number of firms providing coverage. Because losses stem from a small number of huge events, the insurer may have trouble covering the costs. Insurers typically compensate by raising rates after events, but that may not be enough.

"In the absence of adequate reinsurance, the firm may go bankrupt or may choose to exit a state where there is a substantial exposure to such catastrophic risks," according to the authors. After Katrina, for example, several major insurers either left coastal states altogether or chose not to renew certain policies.



NOTE: In 1989 Hurricane Hugo brought just over $3.7 billion in losses.
SOURCE: Insurance Information Institute; adjusted to 2005 dollars

In South Carolina, according to Allison Love of the S.C. Insurance News Service, Allstate declined to renew 10,000 policies; State Farm, 1,000; and the S.C. Farm Bureau, just under 3,000. — Betty Joyce Nash

UPDATE

Progress of Southeast Rail Corridor

An 850-mile high-speed rail corridor stretching from Washington, D.C., to Florida continues to exist on paper only. But in the 18 months since *Region Focus* last reported on the Southeast High Speed Rail Corridor, some progress has been made.

The U.S. Department of Transportation designated 10 regional high-speed rail systems in 1992, including the Southeast Corridor. The overarching idea is to provide an alternative intercity means of transport beyond airplanes and automobiles, perhaps helping to contain traffic congestion on roads and at airports.

Earlier this year, the N.C. Department of Transportation's Rail Division collected a $1.5 million grant from the Virginia Rail Enhancement Fund for completion of an environmental impact statement for the Richmond-to-Raleigh stretch of rail. Meanwhile, fieldwork has been conducted for several other portions of the corridor.

Kevin Page, chief of rail transportation with the Virginia Department of Rail and Public Transportation, says this methodical approach is necessary. All parties want to be confident about the costs, benefits, and feasibility of the project before trying to secure federal funding for construction. On the current schedule, hearings on the latest environmental studies will conclude in 2010.

"Without the plans we will continue to be unsure about the level of funding required, and ... that is why the environmental studies continue," Page says. — Doug Campbell

Federal Minimum Wage Increased

BY VANESSA SUMO

Included in the bill providing funding for the Iraq War that President Bush signed into law in May is a provision to raise the federal minimum wage, the first legislated increase in a decade. The wage floor will go up by $2.10 an hour, in three stages, to $7.25 over the next two years. Tax breaks were also part of the provision, ostensibly to offset some of the additional costs that will be borne by small-business owners, who fought hard against an increase.

The objective of a binding minimum wage is to give low-income earners a boost, but this is arguably not the only way to accomplish the same goal.

Proponents say that raising the minimum wage is long overdue. (Many states have moved to raise the state minimum wage ahead of this legislated federal increase. In the Fifth District, only South Carolina doesn't have a state minimum wage law.) Due to inflation, the $5.15 an hour that minimum wage workers earned prior to the change bought about 23 percent less than when lawmakers last raised the rate in September 1997. Moreover, a full-time minimum wage worker took home about 38 percent less than the poverty income level for a family of three, according to the Economic Policy Institute, a liberal-leaning think tank. Thus, it would appear that raising the minimum would be of great help to this particular group.

But that assumes everyone gets to keep his job. In a competitive labor market, wage levels adjust until the amount of labor demanded by firms equals the amount supplied by workers. Legislating an effective wage floor prices some workers out of the market, because employers are unwilling to pay them the minimum wage given those workers' skill sets. So, those who are able to acquire or retain their jobs are made better off, but those who are kept out of the labor market are made worse off. In short, according to standard economic theory, increasing the minimum wage causes more low-wage workers to become unemployed, typically the least skilled and least experienced, hurting some of the very people that lawmakers were trying to help. Of course, in response to a minimum wage increase, companies could act to reduce other components of their labor costs (fringe benefits, hours worked, etc.) to keep their total expenses unchanged. But if other forms of compensation are reduced, it is unclear how employees are affected on balance.

Finding a mainstream economist who supports a hike in the minimum wage used to be like finding a rare bird. However, a few studies in the 1990s prompted a reassessment. For example, empirical research at the state level by economists David Card of the University of California at Berkeley and Alan Krueger of Princeton University found a small but positive employment effect from raising the minimum wage. Many economists remain skeptical of Card and Krueger's findings, but some have conceded that the negative effect on employment could be more modest than once thought.

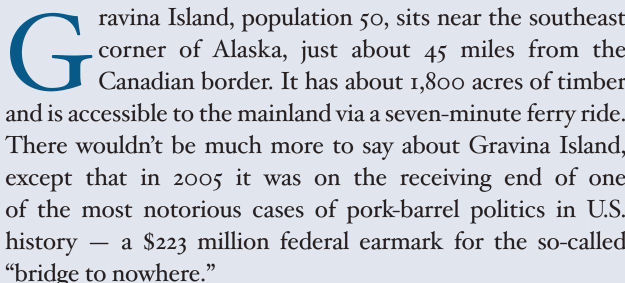
In part, this is because a relatively small share of overall workers receive the minimum wage. Most earn wages well above the minimum, and thus are neither directly helped nor harmed by a change. As Charles Brown, an economist at the University of Michigan, has written: "It is hard for me to see evidence that minimum wage increases have benefits which would overcome an economist's aversion to interfering with reasonably competitive markets. But the case against the minimum wage seems to me to rest more upon that aversion than on the demonstrated severity of any harm done to those directly affected."

The objective of a binding minimum wage is to give low-income earners a boost, but this is arguably not the only way to accomplish the same goal. In fact, setting a wage floor is often compared with the Earned Income Tax Credit (EITC) program, which reduces payroll taxes paid by low-income families.

The EITC has been praised by most quarters because the way it is designed provides an incentive for people to work more. The amount of credit that families are entitled to increases as their income from working increases. This credit plateaus and then slowly declines as their income rises further, presumably so as not to completely offset the incentive to work. Some studies show that the EITC has had a positive effect on the supply of labor, especially along the "extensive" rather than the "intensive" margin. That is, the EITC has encouraged those previously unemployed to enter the labor force, particularly single mothers, rather than stimulating workers to put in more hours.

Thus, by raising employment the EITC seems to address what was primarily the problem with the minimum wage program. Moreover, in comparing the effect of both policies on family income, economists David Neumark of the University of California-Irvine and William Wascher of the Federal Reserve Board of Governors find that "the EITC has been more beneficial for poor families than is the minimum wage." Nonetheless, the Economic Policy Institute maintains that *both* programs are needed, that "the EITC and minimum wage work in tandem to raise a family's income." **RF**

Democracy and Other Failures



PHOTOGRAPHY: GETTY IMAGES

The theory of public choice helps explain why we get stuck with so many bad economic policies. Or does it?

BY DOUG CAMPBELL

Gravina Island, population 50, sits near the southeast corner of Alaska, just about 45 miles from the Canadian border. It has about 1,800 acres of timber and is accessible to the mainland via a seven-minute ferry ride. There wouldn't be much more to say about Gravina Island, except that in 2005 it was on the receiving end of one of the most notorious cases of pork-barrel politics in U.S. history — a $223 million federal earmark for the so-called "bridge to nowhere."

The Ketchikan Gravina Island Access Project, as it is officially known, became the poster child for seeming government waste. The planned span would be as long as the Golden Gate Bridge and high enough for cruise ships to pass underneath. How on earth, watchdog groups wondered, could legislators back something that would cost so much and benefit so few? It was, as one critic put it, "an abomination."

The bridge's defenders make some reasonable points about its actual merits. But putting aside that debate, there exists a theory which perfectly explains any such apparent legislative breakdown. It is called public choice, and it has quietly become the default lens through which many social scientists view democracy.

Public choice uses economic principles to analyze political activity. It assumes that people are primarily self-interested, be they businessmen or politicians. That's in contrast to traditional political theory, which holds that government agents put aside their private interests when working for the public.

What's also different about public choice theory is that it assumes that most voters don't pay attention to the details of the legislative process, simply because their ballots are, on an individual basis, highly unlikely to decide an election. In other words, their votes don't really matter. As a result, politicians cater to the small groups of voters who are paying attention — special interests — thus maximizing their chances of re-election. In some cases, special interests can be lobbies representing large groups of workers, like those in the steel industry; in other cases, they may be small groups in specific congressional districts that benefit from certain projects — like tourism workers gaining from the proposed Gravina bridge. Public choicers call this an example of "diffused costs, concentrated benefits."

The logic is persuasive, especially when applied to other examples of uneconomic policies on trade and certain subsidies. Though public choice theory faces legitimate objections, in general it has held up well since its introduction 50 years ago. It is at base a critique of democracy, pointing out the difficulty in obtaining socially efficient outcomes under majority rule.

(In brief, one of the leading alternative takes on public choice has come to be associated with Nobel Prize-winning economist George Stigler. The idea is that society is always going to have an interest in doing things like helping unemployed steelworkers or building bridges somewhere. Of all the ways of achieving such goals, this view goes, our flawed democratic process might actually be the most efficient. Efforts such as lobbying that might seem wasteful are only so when compared with outcomes in an unattainable, perfectly frictionless world. This doesn't make public choice wrong, but it does distinguish between its explanatory analysis of democracy and whether or how to fix it.)

But now comes perhaps public choice's most significant challenge yet, and it comes from an economist at the very university where the nation's preeminent public choice center is housed.

In his new book, Bryan Caplan turns public choice theory on its head: It's not that voters end up with (admittedly bad) policies that they don't want, Caplan argues. Rather, the public is getting precisely what it demands — policies that make voters feel good but don't

make any economic sense. Blaming special interests misses the point. Voters actually *like* protectionism and bridges to nowhere. As Caplan puts it in *The Myth of the Rational Voter: Why Democracies Choose Bad Policies*, "If I am right, then a great deal of published research is wrong." Equally, if he is right, then the entire social science profession might have to rethink its approach to reforming the democratic process.

Public Choice

Anthony Downs, in his landmark 1957 book, *An Economic Theory of Democracy*, described that in a two-candidate election, the smartest course was for a politician to cater to the voting preferences of the median voter. The trick is to move as close to the center without overlapping with the rival platform, thus taking along all of the extreme voters and the highest number of swing voters. The "median voter theorem" is an oversimplification, as it strictly holds only when there is a single choice at stake. But it makes it easier to visualize how the democratic process actually works. Downs modeled democracy as a market where politicians were motivated by winning elections more so than upholding the public interest. With this view of politicians as rational and self-interested, Downs helped lay the foundation for public choice theory.

James Buchanan, teaching at the University of Virginia, formalized the public choice concept with colleague Gordon Tullock. The duo's *Calculus of Consent*, published in 1962, is considered public choice's seminal text. The premise was straightforward: "Our approach is based on the idea that, insofar as this pursuit of self-interest does take place, it should be taken into account in the organization of the political constitution," the authors wrote.

After a stop at Virginia Tech, both Buchanan and Tullock eventually settled at George Mason University, where the Center for Study of Public Choice is now housed. In 1986, Buchanan won the Nobel Prize in economics for his work on public choice theory. What was once a revolutionary approach to examining political behavior had become the norm.

Maybe the approach doesn't sound so radical today, nor all that consequential. After all, if politicians are mostly interested in getting reelected, they ought to be simply implementing the will of the people, right?

The problem with that story is that voters are also self-interested. And that doesn't necessarily mean they support policies which will make them better off. Instead, it means they are unlikely to spend much time figuring out what will make them better off in the first place. According to rational choice theory, they are likely to make a calculation about the benefits they would receive from their vote versus the costs of becoming informed and then casting a ballot. More often than not, because of the large pool of votes cast, an individual vote doesn't count (much), so the rational choice is not to spend time becoming informed about broad issues. (At the same time, voters still tend to care about narrow issues of local concern.) This contrasts people's behavior in the regular market. When buying a car, a consumer is likely to research the options before making a selection; when in the voting booth, such research may seem pointless.

With most voters uninformed, special-interest groups hold great sway. Tullock put it this way: "Members of Congress wishing to be reelected will take careful account of issues and bills that strongly affect small minorities, whether it is a reduction of transfers to them, an increase in the taxes specific to them (like road taxes for freight carriers), or a special tax exemption. Considerably less attention is given to the issues affecting the general population because the voters are unlikely to be strongly motivated to express their support or favor at the ballot box."

Here is an example of how it works in practice: Most economists agree that free trade makes countries better off. But protectionist policies that make little economic sense abound. This is because the pain of losing steel jobs is both obvious and concentrated, while the pain of paying, say, $200 more per car because steel is more expensive is ambiguous and widely dispersed. So politicians tend to respond to those most acutely affected by trade — the steelworkers and their representatives who complain rather than the average consumer.

According to public choice, special-interest groups seek "rents," or public privileges transferred for private use. Some people would call the Gravina Island bridge project an example of a rent. Through the phenomenon called "logrolling," politicians agree to back each others' pet projects, rolling up all these earmarks into big spending bills that sail through to law.

There are a couple of problems with this process. For one, having an entire industry of people devoted to seeking political favors is wasteful, because many of these lobbying efforts fail. And many of those that don't are inefficient. A direct transfer to struggling steelmakers might be more efficient. But since such transfers are typically hard to accomplish in the public realm, they turn into indirect subsidies, ultimately hurting consumers and reducing incentives for steel companies to innovate and invest in their futures.

Into the Mainstream

Geoffrey Brennan, an Australian economist and former president of the Public Choice Society, is now a visiting professor in a joint program between Duke University and the University of North Carolina at Chapel Hill. Brennan says that democracy, as seen through public choice, has two main problems to deal with. First, some groups of people won't be able to form lobbies to protect their interests as well as other groups — a social justice issue. The second problem is that even if everybody were able to defend their interests, the kind of policies that get adopted in this mutual exploitation

model are undesirable. "What public choice is saying is that these are characteristic features of the whole system," Brennan says.

Oftentimes, the public choice remedy for such "government failures" is to turn to the market. For this reason, public choice followers often get branded as free-market zealots. This is not an entirely fair criticism.

Yes, public choicers say, markets do fail. But the relevant question is, compared to what? Assuming that government can always do better is just folly. That's why, on balance, the public choice solution for many problems is to limit government intervention, where monitoring is weaker and rent-seeking and logrolling are more likely to be factors in producing bad policies. Given the incentives that legislators face to make bad policy, the prudent thing to do is to handcuff them as much as possible by limiting the number of things that get decided in the public sphere. Buchanan called public choice "politics without romance."

Other market-oriented alternatives include letting more than one government bureau provide the same service, thus promoting competition and theoretically improving efficiency. Term limits and line-item vetoes are other standard public choice remedies to government failure (which might include the enormously high — 90 percent or more — re-election rates for House incumbents).

But return to public choice's central premise — that voters are rationally ignorant. The implicit idea here is that voters are getting policies that they don't want. Now there is a young economist who questions this premise. Voters are not ignorant, says Bryan Caplan. They are *irrational*, and their views are reflected in the irrational policies they get.

Rational Irrationality?

In 1995, economist Donald Wittman, at the University of California at Santa Cruz, published *The Myth of Democratic Failure: Why Political Institutions Are Efficient*, based on several papers that appeared some years before. In it, Wittman attacked public choice as being based on several bad assumptions. Caplan was most intrigued by Wittman's central critique — the assumption that voters are "extremely stupid." Wittman had a number of reasons why this might be a stretch, including that voters process more information than public choice economists give them credit for. What's more, Wittman asserted that even if people are "stupid," it doesn't matter because their random biases will even out in the aggregate, producing economically sound policy.

This is true, thought Caplan, so long as those biases are in fact random and not systematic. But what if voters are systematically stupid? Or, put another way, irrational? That is, what if voters in large, consistent numbers hold beliefs that are out of touch with expert economic thought? That would be a completely different problem than the one public choice economists had identified. In many cases, it would mean that irrational voter beliefs and irrational economic policy were identical. Perhaps special-interest-bound politicians weren't shoving bad policy down the voters' throats at all. Perhaps voters were swallowing precisely what they had already decided tasted good.

To figure this out, Caplan got his hands on a relatively fresh data set. It came from a 1996 survey commissioned by the *Washington Post*, Kaiser Family Foundation, and Harvard University Survey Project. Called the Survey of Americans and Economists on the Economy, it was based on interviews with 1,510 members of the general public and 250 Ph.D. economists.

One of Caplan's goals was to overcome the standard criticism about studies like his: So what if economists and the public think different things? What if economists are wrong?

Economists get a lot less respect than other experts. Few people question the advice of medical doctors like they question the counsel of economists. Eat less fat? OK. Knock down trade barriers? Not so fast.

Caplan explains how he set out to establish the correctness of some fundamental economic concepts. Typically, the biases of economists are labeled as being either self-serving or ideological in nature. But these are testable biases, Caplan says, and the Survey of Americans and Economists could be used to test for them. If economists are biased by their income, then both wealthy economists and wealthy members of the general public ought to hold the same views. Same for ideological bias — conservative economists and conservative voters ought to agree, Caplan says. But his parsing of the survey shows they don't — that being an economist is much more likely to make a person

Exceptions: Trucking Deregulation

Of course, there are examples where public choice theory seems to fall short. Diffuse populations *have* come together to support good policies in the face of staunch special-interest opposition. The story of trucking deregulation is relevant here. Trucking for most of the 20th century was tightly regulated, with new carriers having to be completely unopposed before receiving certificates to operate. Rules also required that carrier rates be made public, allowing for protests from competitors. And later, rates were fixed. The result was an industry with high barriers to entry and a complicated web of routes that served few interests beyond the trucking companies and the union members they employed.

As studies mounted about the steep cost of regulation, a movement began to open up the industry to competition and lift rate restrictions. Despite intense counter-lobbying from unions and trucking firms, a diverse coalition that included liberals and political appointees from both Republican and Democratic administrations succeeded in ultimately getting Congress to approve the Motor Carrier Act of 1980, which effectively deregulated trucking.

Does the case of trucking deregulation undermine public choice? Not quite. Most public choice theorists would probably agree that when conditions get particularly bad — as the trucking industry had become — then reform is possible. There was in essence a supermajority of the voting public in favor of deregulation, a force too powerful for special interests to overcome.

— Doug Campbell

think that markets are a good thing, whether that economist is of a liberal or conservative persuasion, rich or not so rich.

Having dismissed the notion that economists are biased, Caplan makes the reasonable leap that their views might rightly be judged as expert. As such, where the public disagrees, the public is likely to be wrong. And the differences that Caplan logs are legion, specifically with regard to views on free trade, immigration, wage and price controls, and the overall state of the economy. "The public really holds, for starters, that prices are not governed by supply and demand, protectionism helps the economy, saving labor is a bad idea, and living standards are falling," Caplan writes.

Reorienting Public Choice

Now, what Caplan says he sees here flies in the face of conventional economic thought. When building mathematical models of human decisionmaking, economists almost always take a rational expectations approach — that people cannot be fooled on a systematic basis, and they learn from their mistakes. In the public choice model, the rational part of voter decisionmaking is not to spend much time invested in learning about the issues because individual votes hardly matter. In Caplan's model, voters are being rational about the price of their irrationality.

The distinction between "ignorance" and "irrationality" is important. Being ignorant, as standard economic theory sees it, means that a person may not have seen the value of becoming informed, but if he had, then his viewpoint could have been changed to reach the proper conclusion. Like, if people were presented with the facts about the benefits of trade, then they would favor it over protectionism. Irrational people, on the other hand, still refuse to rethink their position even when presented with contradictory evidence.

The reason irrationality can exist on a systematic basis, so far as economic beliefs go, is because of the small cost of holding those beliefs. "One hundred and fifty million Americans can be wrong, and in fact easily," Caplan says in an interview. "You could think the craziest thing in the world about politics, but if you have one vote, it won't come back to hurt you. People can have comfortable beliefs rather than true beliefs."

In this way, Caplan seeks to reconsider public choice theory. Why spend so much time building models with rational actors if, in fact, voters are irrational? In his book, Caplan uses the example of economists trying to explain why economic reform is so unpopular in developing countries. How come so few people support changes that would make them better off? To Caplan, the answer is obvious: People are irrational.

"When you put that together you get a very simple picture of how the world works," Caplan says. "Voters vote on the basis of what is best for society, but their beliefs are so misguided that you have people unselfishly voting for policies that are bad for people."

Where Caplan agrees with standard public choice followers is that democracy doesn't deserve its hallowed status. But where public choice sees democracy as flawed because of its tendency to be controlled by special interests, Caplan sees it as flawed because it allows people to believe things that can hurt their standard of living. The electoral process effectively allows people to behave irresponsibly, in ways that are ultimately irrational.

A Fresh Look At Reform

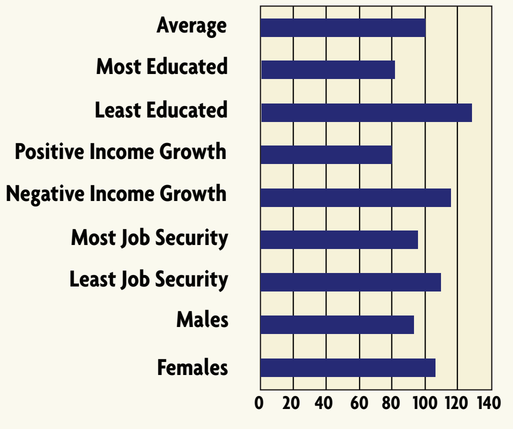
Standard public choice thinking on how to improve democracy is to let the private sector handle more efforts traditionally handled by government. In this way, the costs of poor decisions become more visible, so holding irrational economic beliefs becomes harder to do.

Caplan agrees with this assessment. But where public choice views the voting public as somewhat hopelessly ignorant, Caplan believes that an "irrational" public may actually be receptive to education, and possibly be improved by it. He bases this approach on his own study — the more educated people are, the more likely they are to think like economists. (Also in this category of people who think more like economists are men and those whose incomes have grown a lot over their careers.) Perhaps with earlier intervention, economics could make their principles more comforting to the general public.

To make economic education more palatable, Caplan says, economists need to change the way they sell their ideas. Instead of perpetually hedging their statements, economists could be bolder, if not blunter: Price controls cause shortages and surpluses, economists should say. End of statement, with no need for footnotes or disclaimers of why this statement is not absolutely and always correct. And then, make this sort of material standard in primary and secondary education. Instead of teaching state capitals, teach supply and demand. "We have something useful to say here. It's hard to swallow, so we've got to be persistent," Caplan says.

Thinking Like An Economist

Factors that make people more likely to think like an economist include education, positive income growth, and being male. This graph plots the degree to which average people disagree if one is a Ph.D. economist and one is not.



SOURCE: *The Myth of the Rational Voter* by Bryan Caplan

Perhaps more controversially, Caplan believes that certain groups of people are more qualified to make economic decisions. He favors panels of economic experts — modeled, perhaps, on the Federal Reserve Board or the Council of Economic Advisers (CEA) — to rule on matters that materially affect living standards. "The Supreme Court is able to declare something unconstitutional," Caplan says. "Why can't the CEA declare something uneconomical?" He even goes so far as to float, but not quite endorse, the idea of giving extra votes to more educated people, since their views will be more compatible with mainstream economic thought.

We are left with an argument that is soundly reasoned, compelling, and incredibly elitist. Also, as some critics have pointed out, Caplan's argument asks that people think more like economists — except when it comes to understanding his own model, which undermines standard rational expectations economic theory.

To Caplan, his work adds up to something in between a reorientation and a debunking of public choice theory. "I can still accept 75 percent of [public choice theory], but with a big asterisk," Caplan says. "It's not so much about sneaking bad policy underneath the radar as it is tapping into public opinion."

Reconciling Ignorance and Irrationality

So, do pork-barrel projects and protectionist policies endure because voters are ignorant or because they want them? William Niskanen, former acting chairman of the CEA during the Reagan administration and current chairman of the Cato Institute, the libertarian think tank, is familiar with both Caplan and his recent work. He is unconvinced.

The weakness in Caplan's premise, Niskanen says, is his reliance on a survey with open-ended questions. It may be that the general public believes that raising the minimum wage is a good idea while economists disagree. But if you extend the question with the information that raising the minimum wage may decrease employment for the least-skilled workers, the public may be less enthusiastic. And if so, then that is evidence against systematic irrationality. It is, quite plainly, rational ignorance.

"The responses to public opinion polls that he uses as proof of his conjecture I think are quite misleading," Niskanen says. "The questions don't convey anything about the effects of the policy. Their response is consistent with the general premise of public choice that voters are rationally ignorant about most detailed public policies."

If voters were in fact systematically irrational, we would expect to see more evidence of it in their actual behavior — their "revealed preferences," in economic jargon. Niskanen points to his own research on presidential election rates of incumbent parties. The rate of re-election goes up with economic growth, down as a function of government spending, and down sharply if the nation is at war. Similarly, other research has shown that people move to states with solid economic growth and away from those with growth in government spending and taxes. "The response to macro-economic performance, public finance, and war conditions to me looks quite rational," Niskanen says.

This is a new debate. Academics have yet to weigh in with substantial responses to Caplan's work, making it difficult to declare at this stage whether *The Myth of the Rational Voter* will become landmark or a passing fancy. (For an academic book, it has been reviewed in a surprising number of popular magazines, including *The New Yorker*, *The Economist,* and *The New York Times Magazine.*) What's encouraging about this debate is that it's even happening. The United States is a rich nation, with one of the best-functioning democracies in the world. Public choice theory has identified the core of some of democracy's flaws, and now Caplan is trying to advance our understanding of government failure.

Still, if you're new to this discussion, you may understandably be confused and depressed. Public choice sees you as manipulated by special interests and probably lacking the wherewithal to improve democracy with the dismantling of the regulatory state. Bryan Caplan thinks you are getting precisely what you've ordered, and you'd do much better to listen to him or let other experts decide the details of U.S. economic policy.

There is, however, one thing about which both public choicers and Caplan agree: Most people's views about many economic policies are woefully off the mark. **RF**

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Risky Business

Have recent innovations in credit markets made the financial system safer or riskier?

BY VANESSA SUMO

In his annual letter to shareholders five years ago, Warren Buffett made clear what he thought of derivatives: "financial weapons of mass destruction," he famously called them. Derivatives are financial instruments that allow investors to put down relatively little money in taking bets on the future value of an underlying asset. Critics say that these instruments make it too easy for speculators to take excessive risks. Buffett pointed to the experience of Long Term Capital Management, the hedge fund whose derivative-heavy investment strategy backfired in 1998 and prompted a $3.5 billion bailout to maintain stability in the financial markets.

But despite this cautionary view, the market for credit derivatives and other credit market innovations has been rapidly expanding in recent years. The volume of outstanding credit derivatives soared to $34 trillion in 2006 compared with less than $1 trillion just five years earlier, according to the International Swaps and Derivatives Association. Securitization and single-name credit default swaps, once exotic names, are now just plain vanilla. More sophisticated structures are entering the market, offering investors new risk and return opportunities.

These innovations have created new ways to distribute credit risk, or the risk of default on a bond or a loan, to a broader set of market players. Strong demand from investors means that lenders are better able to offload and manage risk, which ultimately frees up more capital and funding. Consequently, borrowers benefit by having more credit available at better prices.

Recent events have raised questions about whether financial innovations have gone too far. This summer's financial market turbulence, with the wobbly subprime mortgage market at its center, has burned many investors. The discussion on whether new financial devices have made the system more stable or, as Buffett sees them, "time bombs" which carry dangers that are "potentially lethal," persists as strong as ever.

Earlier this year, some of the leading experts on credit market innovations gathered in Charlotte, N.C., to weigh in on this question. (All the views and comments in this article came from participants during the event, which happened in March.) Overall, credit market innovations should help make the financial system more efficient and more resilient, said New York Fed President Timothy Geithner at the symposium, which was hosted by the Federal Reserve Bank of Richmond. But Geithner is part of the prevailing economic view that certain characteristics of this wave of innovation — its complexity and the market-based nature of credit — require attention. So even as bankers, asset managers, risk managers, and policymakers gathered at the symposium to extol the virtues of this new financial order, they also aimed to address the challenges that have come with remarkable growth in credit markets.

Deeper Markets

Credit market innovations have dramatically changed the way that banks do business. "I would say business has changed for the better," says Donald Truslow, chief risk officer at Wachovia Corp. "[These innovations] have allowed us to be much more effective risk managers ... and [to have] many more tools for helping to balance the risk-reward equation in our institution than we used to have."

For instance, banks have benefited tremendously from the emergence of credit derivatives. They now have a feasible way to hedge against the risk that a borrower will default, and also a better way to diversify or avoid huge concentrations of one type of exposure in their portfolios. Instead of "originating" loans and then holding on to the risk that borrowers won't repay, banks today can lend money and then transfer that credit exposure to others through the capital markets. By "isolating" the risk of default and then selling this risk to investors who are willing to hold it, credit risk becomes a tradable asset.

The most widely used credit derivative, the credit default swap, helps illustrate this process. It is a contract that transfers the risk of default from the protection *buyer* (the bank) to the protection *seller* (the counterparty). The bank pays a premium for this protection and the seller of the credit default swap agrees to compensate the bank in the event that the borrowing company cannot or is unwilling to pay its loan. Alternatively, banks may wish to *sell* protection in order to gain exposure to other types of borrowers and further diversify their portfolios.

But the most dynamic area in credit markets in recent years comes from an impressive array of alphabet soup structures that slice, dice, and distribute credit risk. One

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such type of instrument is called a "synthetic" collateralized debt obligation. Traditional collateralized debt obligations involve the transfer of loans to a "special purpose vehicle," which is responsible for bundling and repackaging a bunch of these loans and then issuing them in groups, or "tranches," with different levels of seniority that determine the order of repayment. However, many loans have confidentiality clauses and transfer restrictions, which makes it difficult for banks to set up this type of credit structure. But with the widespread use of credit default swaps, banks can now replicate this arrangement by pooling together swaps instead of loans.

Such instruments target different investors by giving them the opportunity to invest in or sell protection on a particular tranche or slice of losses in the event that companies in that portfolio default. For instance, an investor could agree to compensate a protection buyer on the first 3 percent to 7 percent of losses of a portfolio. Other investors can take a slice of the remaining exposure, depending on their appetite for risk. Some investors may be willing to take on more risk in exchange for higher returns. Equity tranches are the riskiest and the first to absorb losses. These are sometimes called "toxic waste" because of their high exposure to risk. But separating this exposure also allows the creation of senior tranches that earn AAA credit ratings. It should be noted that, in the context of mortgage-related securities, some observers have recently questioned the accuracy of credit ratings on complex financial instruments.

A wide range of instruments with varying risk and return opportunities means that there is potentially something to satisfy every taste, thus encouraging more players to participate in the market. The more participants there are, the easier it will be to buy and sell these credit instruments at prices that everyone can see, which in turn attracts more investors. Ultimately, credit risks are spread out to those who are better suited to hold or trade these risks, which should make financial markets less volatile. "On its face, a wider dispersion of credit risk would seem to enhance the stability of the financial system by reducing the likelihood that credit defaults will weaken any one financial institution or class of financial institutions," says Fed Board Governor Randall Kroszner.

The consequences of these new instruments may be too early to assess, but the experience with earlier vintages offers some evidence that credit market innovations have made financial markets more stable. For instance, the U.S. financial system was able to absorb the substantial scale of corporate defaults that peaked in 2002, Geithner says. He added that there hasn't been strong empirical support that derivatives increase volatility in financial markets, nor has credit market innovation so far resulted in a large increase in leverage in the corporate sector.

Credit market innovation may also smooth credit cycles — the ups and downs of the volume of credit extended to companies. Before credit derivatives were traded, banks adjusted their supply of credit mostly in response to their own loan review process, which came with significant lags to actual turns in the credit cycle. But with a growing credit derivatives market, the price and quality of credit has become more transparent, such that banks may be better able to anticipate and manage the effects of the turns in the credit cycle, according to the 2006 International Monetary Fund (IMF) Global Financial Stability Report. This allows them to act on price signals sooner and adjust their credit portfolios in a more gradual manner, thus creating less volatility in credit supply.

Mark Carey, an economist at the Fed's Board of Governors, is optimistic about less cyclicality in credit supply. "It's been my observation that a crunch happens when people start to feel that they don't understand what's happening, and there's more knowledge of credit risk now than there was 10, 20, 30 years ago," Carey says. "Even though there are more complicated products, and certainly in the next downturn some sellers of credit protection are going to get wiped out, as long as understanding continues to grow, the market will function very efficiently."

The Risk of Spreading Risk

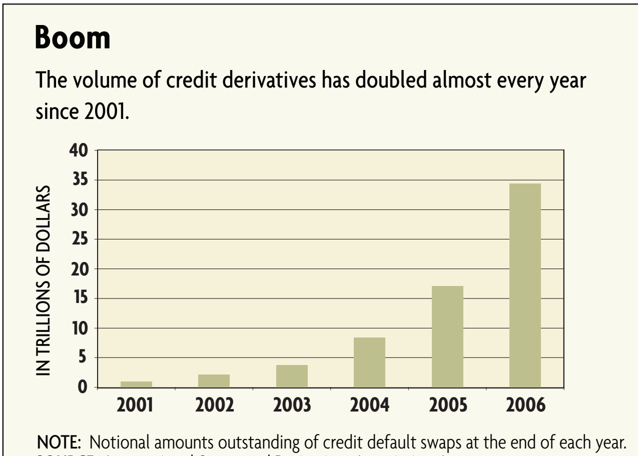
Credit market innovations can promote financial stability by spreading out the potential pain of a market disruption. However, there is a concern that the same process that allows more participants to carry and trade risk also gives them the opportunity to accumulate a lot of it. In other words, there may be more hands to pass the risk around, but that risk could still be concentrated in the hands of a few.

Hence, diversity, in terms of the type of participants, their strategies, and the factors that influence their behavior, significantly determines the liquidity of the credit risk transfer market, says Todd Groome, an economist at the IMF. Liquidity, or the relative ease with which a buyer and seller can trade, is especially important in times of financial stress, in order to ensure that a rapid reshuffling of assets does not trigger a sharp change in market prices. "If I look around in the market and everybody looks like me, then that's not a good thing," Groome says. "They're likely to be influenced for the same reasons that I'm influenced to seek liquidity at the same times."

Nonbank financial institutions have been much more active in credit markets in recent years. This has enhanced the "transferability," or the liquidity, of credit risk in the *primary* market; that is, the ability of banks to find a willing buyer for the credit risk on their balance sheets. Once that risk has been sold, the relevant question becomes, are there enough buyers and sellers out there in the *secondary* market to keep financial markets steady in the event of a disruption?

Investors with longer-term horizons such as insurance companies, pension funds, and mutual funds may be looking to buy credit risk to satisfy their asset-liability manage-

ment objectives but not necessarily trade it. What this implies, according to Groome, is that the private sector response to market disruptions increasingly is tied to one group of investors: the hedge fund community.



Hedge funds typically invest amounts well in excess of their capital base on complex trading techniques and instruments, in pursuit of high returns promised to wealthy clients. They are not subject to the same regulations as many other financial market players. There is a concern about hedge funds using a lot of leverage and investing in instruments that themselves can be highly leveraged, like derivatives. But because of the nature of their strategies, hedge funds are very active in the credit market. "The nimble investor out there, the guy looking for relative value is really centered in the hedge fund community ... they're the ones buying distressed institutions, buying portfolios, and providing lines of credit," says Groome.

This invites the question: How diverse is the hedge fund community? That may be a difficult one to answer, although a recent experience can provide some perspective. In May 2005, debt downgrades of some automakers caused a painful period of turmoil in the credit derivatives market. Some hedge funds closed as a result. But according to the IMF, that disruption was relatively limited and short-lived, primarily because other hedge funds with diverse investment strategies and sufficient capital thought that those credit instruments were a bargain. "[Hedge funds] could lean against the market and within three to four days of the major downdraft provide important stabilizing liquidity," says Groome.

But with the growing role of hedge funds in credit markets, Kroszner thinks that banks which trade with and lend to hedge funds must ask whether they "have enough collateral to protect them against a stress scenario that goes well beyond the recent benign experience in credit markets." Large losses to hedge funds can threaten financial stability by severely affecting banks that are at the core of the financial system. Prime brokers, for instance, are typically large globally active investment banks that provide leverage and issue credit lines to hedge funds, along with the business of consolidating a hedge fund's trades with several dealers. A crucial part of the structure rests on these core institutions that act as gatekeepers to the broader financial system.

Thus, in times of stress, how much of a shock absorber can these banks be? Effective risk management is key. "The important thing is to understand the risks that are in your book," says Thomas Daula, chief risk officer of investment bank Morgan Stanley.

Adam Gilbert, managing director of risk management services at JPMorgan, another investment bank, thinks that stronger liquidity management and capital practices have put financial institutions in a position to be that shock absorber. "The extent to which one might do that in any particular circumstance will be a function of the environment at that time, but we think about potential problems or disruptions in an opportunistic way rather than trying to head for the door," says Gilbert.

The difficulty of managing these risks is exacerbated by the complexity and short history of these new credit instruments. Investors take positions based on what they think will happen in the future, taking into account certain risks and scenarios. But because there may be behaviors and relationships that they do not yet understand, even the most sophisticated investor will be vulnerable to unanticipated losses.

There is also concern that transferring risks may have created incentives for financial institutions to overextend credit and assume excessive credit risk. If the credit risks attached to a loan or a bond can be sold off relatively easily, then it may not matter much to the lender whether the borrower eventually pays up. The recent travails in the subprime mortgage market and the relaxation of credit standards there come to mind.

But there are signs that credit standards on the corporate side may have loosened as well. The concerns are naturally coming from investors of these instruments, such as hedge funds. Samuel Cole, chief operating officer of BlueMountain Capital, a New York-based hedge fund, thinks that the deals the market was seeing earlier this year are different from the ones of just a few years ago, that there has been "a steady deterioration of credit quality."

The volume of leveraged loans (those issued by companies with a lower credit quality) with few financial covenants attached, have been setting records and were absorbed by the market "with hardly a speed bump," according to a January 2007 report by Standard and Poor's, a rating agency. The reason for this strong supply was the robust demand for collateralized loan obligations, which quickly repackage these loans and sell them to investors like hedge funds. (A collateralized *loan* obligation is a type of collateralized *debt* obligation that consists of corporate loan exposures.) However, this market is now showing signs of slowing down.

Of course, the ease of selling risk does not by itself cause credit standards to weaken as long as the risk is priced appropriately. Thus, there would be a cause for worry if there is a reason to think that the price is not right.

The Role of Policy

Critics are concerned about the transfer of credit risk outside the banking system. They argue that because these market participants are subject to less regulation and supervision, they are not as effective as banks at managing risks. However, Kroszner thinks that unlike banks which have a "safety net" to support them, lightly regulated entities are subject to more market discipline because their creditors "have stronger incentives to monitor and limit their risk-taking."

Still, many have asked policymakers to regulate this new financial order, from its exotic instruments to the financial institutions that use them such as hedge funds. However, while it may be easy in hindsight to identify financial market mistakes, Richmond Fed president Jeff Lacker says that it is important for policymakers "to guard against Monday morning quarterbacking" and easily concluding that judgments made by financial markets were suspect or flawed. Markets should be assessed on whether they made the right decisions at the time that those decisions were being made, which is not an easy thing to do.

Although financial markets may not get things right all the time, it is difficult for policymakers to assess where the stops should be placed without running the risk of disrupting the flow of the market and, in the process, unintentionally inflicting more harm than good. Thus, financial markets may be better arbiters of whether prices of assets reflect their fundamental values and of seizing opportunities during market disruptions.

But policymakers can still play an important role in mitigating the risks that come with credit market innovation. Although they may not have the capacity to monitor risk concentrations outside the banking system, policymakers can help strengthen the core financial institutions, the shock absorbers of the system, by continuing to make sure that they have the capital and liquidity to survive shocks. The stronger these core firms are, "the more resilient markets will be in the face of future shocks, and the more confident we can be that banks will be a source of strength and of liquidity to markets in periods of stress," says Geithner. Policymakers can also help strengthen these core firms by sometimes taking the lead when a collective action by market participants is deemed necessary.

When the Counterparty Risk Management Group II, a group of private-sector market participants, called attention to the mounting backlog of unconfirmed trades in the credit derivatives market, the New York Fed invited the 14 leading dealers in the market to a meeting, urging them to resolve these backlogs. Delays in confirming trades can undermine investor confidence if they jeopardize the enforceability of trades and if errors in recording these transactions lead to incorrect measurement and mismanagement of market risks and counterparty credit risks. The "Fed 14" has so far been successful in their efforts. Kroszner said that between September 2005 and December 2006, the number of confirmations outstanding for more than 30 days fell by 92 percent, a remarkable achievement considering the rapid growth in trading volume in credit derivatives.

But such infrastructure and other efforts to manage the risks presented by these new credit instruments, while laudable, remain untested for a severe downturn. This makes the question of whether the financial system has become safer or riskier a difficult one to answer. Indeed, these credit instruments have been flourishing in a generally benign and supportive macroeconomic environment with strong global economic growth, low and stable inflation, and healthy corporate balance sheets. The rather tumultuous period that the financial market finds itself in today may be its toughest test so far.

Credit market innovations may make shocks to the financial system less frequent, but they could also make the system more sensitive to a big shock. In this way, Buffet's "time bomb" view may be right. But market participants seem to understand that the task at hand is to find ways to defuse that bomb, to mitigate that violent shock should it occur. The threat of the bad constantly reminds that in order to fully reap the benefits of these innovations, market participants and policymakers must respond to the challenges that accompany them. RF

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Academic Labor Market's Tenure Track Recedes

Even professors can no longer count on job security. But to many academics, tenure may have outlived its appeal anyway

BY BETTY JOYCE NASH

In 1995, South Carolina legislators sought to abolish tenure at state-supported colleges and universities. With rising college costs and shrinking state budgets, lawmakers wanted universities to act more like businesses. The practice of academic tenure, which, at many colleges and universities, effectively guarantees lifetime employment, seemed at odds with this goal. The bill never emerged from committee, but the state did establish standards for periodic post-tenure review "as rigorous and comprehensive in scope as an initial tenure review."

Tenure flaps have erupted periodically over the last century, especially when money tightens or when academics question society and society questions them back. The Red Scare, the civil rights movement, the Vietnam War, and now Sept. 11, 2001, have provoked academic freedom debates. Anecdotes about stifled research commonly circulate in academic circles, professors say. The job security that tenure bestows on faculty members remains imperative, supporters argue.

Yet even though academic tenure persists at nearly all American colleges and universities, fewer academics enjoy its benefits. To save money, colleges now offer fewer tenure-track and more part-time jobs. Today, 63 percent of faculty jobs are off the tenure track. Part-time faculty jobs now approach half of all faculty positions.

Many factors are driving this trend. The very concept of tenure may be out-of-date, critics maintain,

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because it keeps some relatively unproductive faculty in place for too long at the expense of new, diverse blood. Tenure may not even be the prize it once was, with today's faculty candidates worried more about location and other benefits — a good job for a trailing spouse, for instance. These and other developments raise the question: Does tenure remain the most efficient way to nurture research and disseminate ideas to students, a public good so crucial to society's collective knowledge? Or does the tenure system need an overhaul?

Useful Labor Contract or Antique?

Academia's mission is "to explore new ideas, to create and challenge old ideas, to question accepted truths ... and our society asks that of our faculty as a way of providing the best education for our students and for helping to contribute to our material and scientific progress. Now, to do all that inevitably means that some people will be offended by what faculty say and write," says Jonathan Knight. He directs the department of academic freedom, tenure, and governance for the American Association of University Professors. The group advocates for tenure.

Economists have studied the tenure issue from institutional, labor market, and human capital perspectives, among others. Ronald Ehrenberg, a Cornell University economist, has researched a variety of tenure's influences. "There are some costs, but there are also benefits," he says. Like other labor policies, it should be judged by "the extent to which we believe the benefits outweigh the costs."

Tenure is the centerpiece of the quirky academic labor market. It's hard to measure a professor's output and performance since research is long-term and teaching evaluations can be idiosyncratic and reward popularity. Williams College economist Gordon Winston explains that tenure is about inducing people "to make a narrow commitment up front in their careers. And it works." Winston worked in corporations for 10 years before pursuing a doctorate in economics. The main difference between the two was the job guarantee. While corporations may hire for life (unlikely these days), they can more easily substitute one job for another — retraining a worker to move from one department to another, for example. That's nearly impossible in academia. "If you teach romance languages, you teach romance languages and you don't do diddly in the physics classroom," he says.

The six- to 12-year screening process is a transaction cost that helps to insure the institution's investment, with tenure a bargaining chip between would-be professors and the institution. Green professors work for less money than they would if they were "employees at will" like most American workers. (At will simply means people can quit or be fired for any reason other than discrimination.) They do this in exchange for a future shield, should they receive tenure, against inside and outside pressure. Their research may be of obscure and uncertain value, but only time and the market will tell. (The tenure journey is fraught with disincentive, says Boston University economist Jeffrey Miron, because researchers may opt for deadline-friendly projects to meet quotas for papers and books rather than potentially more meaningful, longer-term research. It can also be particularly difficult for female professors, who are expected to crank out papers for peer-reviewed journals at a time in their lives when many are considering having children.)

Tenure discussions inevitably bring up the concept of shared governance, central to the academic workplace. A university is a labor-managed firm, according to economist Richard McKenzie. Tenure offers protection against the peculiar problems that crop up in "academic democracies." In a university, faculty decide curricula, research expectations, class sizes, teaching loads, and new hires. But the burgeoning adjunct faculty common on campus today do not participate.

If alternatives to tenure were in place, would they have the same effect on institutional loyalty and ultimately on governance that tenure does?

Economist Lorne Carmichael of Queen's University in Canada suggests that tenure solves a "moral hazard" issue when it comes to hiring new faculty. Without tenure, professors may not develop institutional loyalty. In hiring decisions, a professor might have an incentive to choose an inferior faculty candidate out of fear of losing his own job. Greg Mankiw, an economist at Harvard University, suggests that shared governance might morph into a hierarchical management structure without tenure.

Economists Antony Dnes and Nuno Garoupa suggest possible alternatives to "reveal the characteristics of recruits and to maintain their own performance post-tenure." Universities could pay more to those charged with hiring, compensating the "decision-makers" for the risks of "honestly revealing the skills of entrants." Or, schools could create tenure for just that group.

Along these lines, Ehrenberg notes: "Absent tenure, faculty will focus on things which make them more marketable and make other universities want them, solely research and no teaching." That's a problem for the students. And the faculty won't have incentive to be involved in governance, he continues, which is a problem for the institution.

But according to Nobel laureate economist Gary Becker of the University of Chicago, tenure need not be formal. Employees of long service in the private sector often have de facto tenure because they possess "firm-specific" capital, he points out. And as for academic freedom, in the United States, several hundred colleges and universities compete for professors. A university interested in keeping and recruiting faculty would be loath to become known as stifling freedom. There is now a growing international market too. And the private sector increasingly needs highly skilled workers, and can often

Full-Time Faculty Nontenure Track at Selected Fifth District Universities

Institution	FT Faculty	% Nontenure Track
American University (private)	555	33.2
Catholic University (private)	344	5.2
Howard University (private)	859	39.2
Johns Hopkins University (private)	1268	49.8
University of Maryland at College Park (public)	2861	51.1
Duke University (private)	1175	35.5
N.C. A&T State University (public)	364	12.6
UNC-Chapel Hill (public)	1382	22.4
UNC-Greensboro (public)	727	27.8
Wake Forest University (private)	450	19.8
Clemson University (public)	1040	19.4
S.C. State University (public)	202	7.9
University of South Carolina (public)	1256	22.5
College of William and Mary (public)	594	16.2
Virginia Commonwealth University (public)	1041	42.6
University of Virginia main campus (public)	1164	24.8
Virginia Polytechnic Institute (public)	1979	36.9
West Virginia University (public)	814	17.6

SOURCE: U.S. Department of Education IPEDS, Fall 2005 Employees by Assigned Position Data File published as appendix to Contingent Faculty Index 2006, American Association of University Professors

offer competitive or superior salaries and research environments for newly minted doctorates.

Cathy Trower of Harvard's Graduate School of Education researches faculty work life. "When we talk to survey doctoral candidates, it's not automatic that they're going into the academy," she says. "If you think of a place like Google, they're competing to be a great place to work."

Suppression of ideas is serious business. Although some say that contracts can guarantee academic freedom, one can only imagine the hassle of proving behind-the-scenes muzzling of research. Todd Cherry, an economist at Appalachian State University, notes that research can be controlled subtly, say, through a call to a dean by an industry executive or elected official. He cites an instance of a high-ranking state official who persuaded a president to remove professors whose research agendas he didn't like: The tenured ones stayed; the nontenured ones departed. Cherry describes tenure as a "mechanism to prevent anticompetitive behavior in the marketplace of ideas."

Without tenure, Cherry says, some entities would be more likely to "skew the [research] outcomes to their benefit, not society's."

Human Capital, Imperfect Markets

The decline in tenure-track positions at American universities seems to be associated with trends in graduation rates. Ehrenberg and colleague Liang Zhang demonstrated that if the proportion of tenured faculty declines, the six-year graduation rate also declines. They found a 10 percentage point increase in the percent of part-time faculty at public institutions is associated with a 2.65 percentage point reduction in its graduation rate. Similarly a 10 percentage point increase in the percent of full-time faculty not on tenure-track lines at a public college or university is associated with a 2.22 percentage point reduction in the institution's graduation rate.

Tenure also corrects an imperfect market for narrow specialties, according to a paper by Kalyan Chatterjee and Robert Marshall, economists at Pennsylvania State University. Academics opt for narrow at the expense of broad skills, making them less valuable in the marketplace should they be unsuccessful at the tenure "tournament." Academics whose investments don't pay off in tenure are out of luck unless the specialty is in demand. Of tenure they say: "Employers prefer it because it encourages increased levels of investment. Employees prefer it since it prevents employers from taking advantage of the erosion of the outside opportunities of employees as they strive for results in their discipline."

The tenure review itself extends over several months as reports and recommendations travel from committee to committee through university levels. Meanwhile, the pressure builds. Richard Fine, an English professor at Virginia Commonwealth University in Richmond, got tenure in 1985. He sweated it because the market was tight, his first child had just been born, and he wondered whether he could secure another job. He had published a book, and articles in refereed and non-refereed journals. "In the mid-'80s, quite a few people in English who did not get tenure did indeed leave the profession, for the foreign service, or work in publishing, or research-related jobs." He echoes many of the tenured who say that tenure is not about a "job for life," it's about freedom to pursue research and protection from not only outside but also from within the institution. Professors need to speak freely in class, sometimes about controversial subjects. He notes that faculty may be fired for inadequate performance after post-tenure review, and that tenure offers no protection against wrongdoing.

Chatterjee observes that, while he has been tenured for 22 years, he felt he could always return to India if he

didn't receive tenure. "It [tenure] certainly safeguards an academic against not just things like this Ross case," he says, referring to the first reported ouster of an academic in 1900 due to outside influence. Edmund Ross of Stanford University was forced to resign after Leland Stanford's widow objected to his research.

Chatterjee notes that tenure protects professors from "fads." Academic administrators may decide that a particular sub-field, such as information systems, is the "wave of the future." There are attempts to direct where one's work should go, and tenure frees professors to pursue the research they find interesting.

Tenure's Changing Face

While Chatterjee and others don't believe that tenure will disappear, it is nonetheless being tweaked. Probation, for instance, now may extend out to 10 or 11 years. Some universities are allowing time-outs for family purposes. Some institutions have established renewable contracts in addition to tenure tracks. Trower reports that a popular option at Webster University in St. Louis is the nontenure track, with perks like a sabbatical every five years. "Something like 80 to 85 percent take the nontenure track," she says. "It's wildly popular."

Still, it remains rare for a university to get rid of tenure. At the University of Minnesota in 1996, because of financial pressures, the administration proposed changes that would have effectively muted the tenure system. A backlash among faculty included a call for a union vote; the regents backed off. Among the handful of schools that have banished tenure altogether are Bennington College and Evergreen State University.

Differences in labor law make comparisons to Western Europe and the United Kingdom difficult. In Europe, many universities are state-run, and those jobs, as with many in those countries, come with protections already, notes economist Dnes at the University of Hull in the United Kingdom. There, tenure was "softened" in 1988, but not completely abolished. "In the U.K., there is still a move from 'probation' to 'permanency' after three or four years into the game, but it is not that tough," he says.

Dnes adds that the real quality sifting occurs when academics apply for full professor. In the U.K., tenure is dominated by standard labor law, which is characterized by employment protection legislation that makes it difficult to fire people anyway, he notes. "This is a very significant difference from the U.S. legal background, which remains dismissal at will under the common law."

Ehrenberg and co-authors Paul Pieper and Rachel Willis tested the labor market tenet that professors should be willing to accept jobs for which tenure is less likely in exchange for more money, and found some evidence that it's generally true. But Trower, who works in a nontenured position, says that money isn't always the best substitute for tenure — there's professional growth, for instance. "Young academics are looking for support from the department and development opportunities," she says. "They expect to be evaluated and want to be evaluated."

Cost-conscious colleges may choose to outsource language classes in low demand. English departments cope with enrollment fluctuations by adding and taking away adjuncts as needed. Trower notes: "The market is at work here and we can't continue to ignore it."

Patricia Lesko, who earned a master of fine arts degree, publishes the *Adjunct Advocate*, a magazine with 100,000 subscribers. She started it in 1992, when she couldn't get anything but part-time teaching jobs. Supply is way out of whack with demand in some fields. "Colleges throw graduates all over the place," she says.

But while tenure remains a powerful hook with which to reel in good minds, surveys indicate work-life balance and location lure academics too. Tenure may survive, but with flexibility. Versatility to young academics today may be what tenure was to earlier generations. That may include the tenure track, but increasingly, it may not. **RF**

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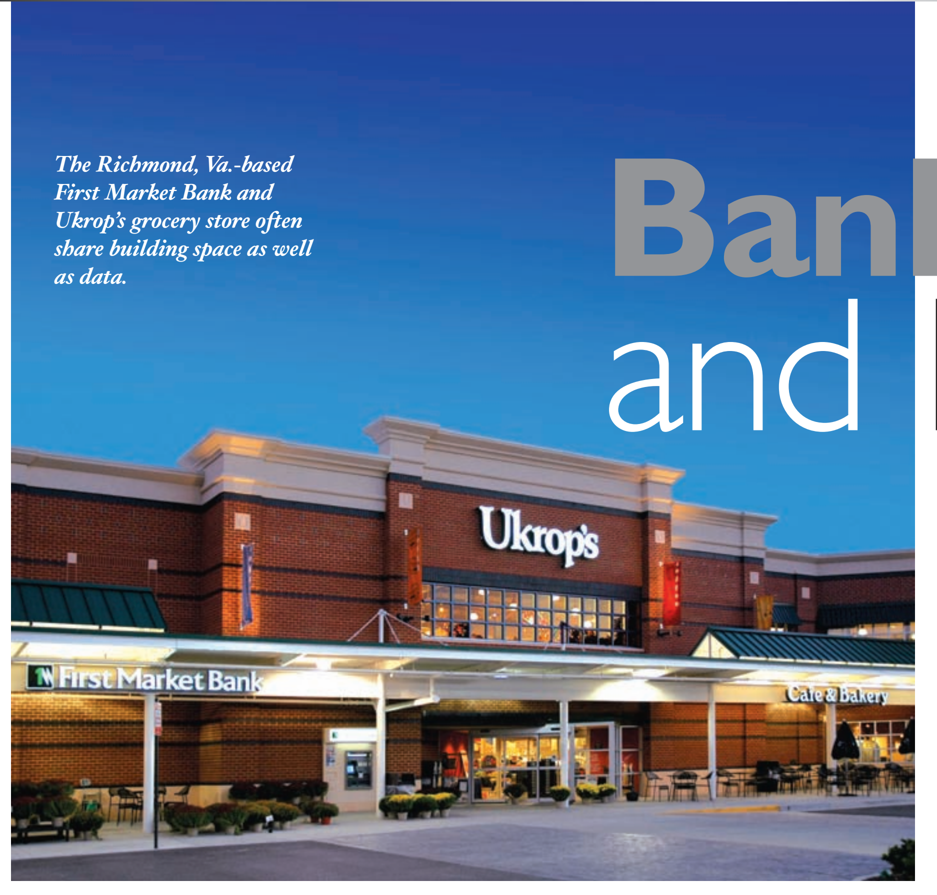

The Richmond, Va.-based First Market Bank and Ukrop's grocery store often share building space as well as data.

Banks and Business

The success of some banking and commerce combinations raises the question of whether maintaining a wall between them makes economic sense

BY DOUG CAMPBELL

A lot of companies describe themselves as one of a kind, doing things that their competitors don't, or can't. In the case of First Market Bank, some of those claims are 100 percent accurate.

First Market is majority-owned by the Richmond, Va.-based supermarket chain Ukrop's and its founding family. Ukrop's got into the banking world in 1997, two years before the loophole allowing it closed. Under current law, this arrangement is forbidden, except for those grandfathered in. Today, First Market is the only thrift in the nation owned by a grocery store, and one of just 13 overall whose owners engage in nonbanking or nonfinancial activities.

Thanks to this unusual relationship, First Market branch managers can (and do) meet each week with Ukrop's store managers, sharing ideas and information. The bank swaps data on its customers with the food store, and vice versa. Ukrop's shoppers who open an account with First Market get a discount on groceries. All of these activities help boost the bottom line, according to First Market and Ukrop's.

Even if Ukrop's didn't own First Market, it could engage in these activities. Doing so would simply require contracts between the bank and its commercial affiliate. But contracts of this ilk are tricky to write and consequently rare. Certainly, bank branches housed in grocery stores are far from uncommon. But the level of coordination and information-sharing that goes on between Ukrop's and First Market is quite uncommon.

"We are very much tied to Ukrop's," says David Fairchild, First Market's chief executive. "Our whole strategy has been to be a part of their market and footprint." It is no surprise that 98 percent of First Market's retail customers are also regular Ukrop's customers.

It's been a profitable relationship. First Market now has 34 locations — 24 of them inside Ukrop's stores in central Virginia, the other 10 freestanding branches. That is more locations than for any other bank opened in Virginia since 1995. About 75 percent of its deposits are from retail customers, while 60 percent of its loans are to businesses. In 2006, net income was $9.6 million.

The potential benefits that can be reaped from Ukrop's-First Market-type combinations have prompted many commercial enterprises to seek entry into banking. With the thrift loophole closed, the remaining way for a regular business to gain banking powers is with a so-called Industrial Loan Corporation, or ILC, charter. High-profile applicants for ILC status have included Wal-Mart and Home Depot.

Originally set up as small companies to lend money to industrial workers, ILCs have evolved since their introduction in the early 20th century. Today, they have almost all the same powers as regular banks — they can gather deposits and lend them out to individuals or businesses, among other activities. Most important, perhaps, is that their deposits are insured. Because of this, banking and commerce combinations may pose risks to the economy. The potential for such risks, as well as some other concerns, was a leading reason why regulators last year imposed a moratorium on ILC approvals. Their concern is that the federal banking safety net will be stretched too wide if it covers the potentially risky activities of commercial operations.

PHOTOGRAPHY: COURTESY OF UKROP'S

This is an important worry. With the effects of recent financial market deregulation becoming easier to see, it may be worth exploring the question of whether the wall between banking and commerce has outlived its usefulness.

Deposits on Aisle 6

The story of First Market Bank illustrates many of the reasons why commercial firms might be interested in owning a bank. In the mid-1990s, banks were opening scores of branches inside of grocery stores — there were 4,800 such arrangements in 1997, with actual in-store branches, not just ATMs. Doing so was cheaper than building freestanding branches, and it provided an instant pool of potential customers.

Ukrop's entertained many proposals from banks to lease space in its stores. The grocery chain was dominant in its central Virginia footprint and interested in a rental fee that went up or down as a percentage of branch receipts, but most banks were offering only flat rent. The most intriguing offer came from National Commerce Bancorporation, a Memphis-based bank that has since been acquired by SunTrust. National Commerce proposed that Ukrop's take a 51 percent ownership stake in a new concern, with the bank taking the rest, a proposal that Ukrop's accepted. (First Market is actually a thrift, meaning it is supervised by the Office of Thrift Supervision but otherwise keeps virtually all the same powers as commercial banks.)

The Bank Holding Company Act of 1956 prohibited almost all banking and commerce combinations. But the law didn't apply to savings banks. Under the Savings and Loan Holding Company Act of 1967, entities called "unitary thrift holding companies" could do what their name implied — own a single savings bank while engaging in a wide variety of nonbank activities. It wasn't until the Gramm-Leach-Bliley Act in 1999 that, going forward, unitary thrift holding companies were stripped of their commercial powers. In addition, unitary thrifts lost their ability to engage in nonbank activities if they were bought. (At the same time, banks and providers of other financial services, such as securities brokerages and insurance firms, were given the ability to merge.)

In 1997, the unitary thrift loophole allowed Ukrop's to gain something it couldn't through a traditional contract: control. "Having ownership, they could control how they do things," says First Market's Fairchild. "The ownership piece helps the bank look a lot like what they want their customers to experience in a normal shopping situation ... Over time, they could get a better return but mainly they could control the quality of the customer service experience."

In 2005, SunTrust acquired National Commerce and then sold its interest in First Market. Today, First Market is owned 49 percent by Ukrop's Super Markets, 11 percent by members of the Ukrop's family, and the remaining 40 percent by a Richmond-based insurance firm called Markel Corp. Throughout all the ownership changes, the institution itself has been operated as First Market Bank.

It's not unusual to find First Market representatives combing the aisles at Ukrop's stores, manning the sampling stations and handing out pamphlets or chatting up potential customers. Its 10 freestanding branches are all within a few miles of a Ukrop's store, and it's safe to say that anybody who banks at First Market is aware of the relationship. "To take the brand beyond Ukrop's is not something we're quite ready to do yet," Fairchild says. "We're hooked up with probably the most important brand in this marketplace. So why would we want to go beyond that?"

The Ukrop's-First Market pairing demonstrates the sort of efficiencies that economists have long posited as those most likely to be reaped in banking and commerce combinations. Yes, many of the "synergies" that Ukrop's and First Market have could be accomplished with contracts, keeping the firms separate. But with combinations, there may be opportunities to both reduce operating costs and to improve information flows such that profits are greater.

On operating costs, obvious sources of savings are in back-office operations and in joint marketing efforts. But these may be dwarfed by the marketing synergies. Ukrop's managers, for example, are knowledgeable about how to attract and retain customers to their stores. So by extension, they are the most knowledgeable in marketing to First Market's customers — whose target market is the same as Ukrop's. This represents a potential cost savings — Ukrop's managers can share their expertise in reaching the Ukrop's sort of customer with First Market managers — adding to the other obvious cost savings of putting bank branches in convenient, in-store spots. It would be difficult, if not impossible, to rent out this sort of knowledge to banks without running into problems like trade secrets and appropriate compensation.

"Information that a commercial company gathers by doing business with its customers can be passed on to the bank and used by the bank to offer valuable services to the customers of the commercial company, and vice versa," says John Walter, an economist with the Federal Reserve Bank of Richmond who has studied banking and commerce issues. "That's the basis for allowing these combinations. It's easier information-sharing of one kind or another."

In other words, widespread combinations of banking and commerce could prove beneficial to the economy. So why don't we see more of them?

Shaky Business?

While the benefits of banking-commerce partnerships are a bit intangible and slippery, the potential costs are fairly clear-cut. The first is the potential conflict of interest. Consider a hypothetical scenario in which a bank owns a hardware store in a small, rural town. What if the bank refused to lend money to potential rivals to its hardware store? Further, the bank could provide cheap loans to its hardware store's suppliers and customers.

Now, this scenario might be unreal-

istic in some settings. As San Francisco Fed economist John Krainer put it: "Firms being discriminated against must not have alternative sources of finance." For lending discrimination to occur, the bank would have to be just about the only one in town. There are only a few such places in the United States today, and with the advent of alternative sources of financing beyond banks, it's hard to imagine how a banking and commerce combination would be able to sustain discriminatory practices.

The greater risk, the one that policymakers pay the most attention to, is the threat to the federal safety net. The Federal Deposit Insurance Corp. covers depositor accounts up to $100,000. The very existence of the safety net makes banks safer places to park money. Because of this, insured banks can raise funds at lower rates than other commercial enterprises.

The existence of the deposit insurance protection means that we run the risk of having too many resources flowing to businesses that are associated with banks, and too few to those that aren't. Creditors, for example, might view such firms as safer because of their bank-backing and the safety net that goes with it. Creditors assume that, should a commercial affiliate of a bank get in trouble, then the loss could be shifted to the bank — whose funds are largely insured. This has the effect of widening the federal safety net, as the deposit protection essentially seeps out to commercial business. Federal law makes much loss-shifting illegal, but the potential still exists and creditors know it.

It's one thing for banks to have this moral hazard problem of insured deposits, but quite another for it to extend to commercial firms. "Observers have pointed out that deposit insurance grants an option to banks, and when a bank is close to default, the way to maximize the value of this option is to increase risk," economist Krainer writes. "Commercial ventures provide a host of ways for firms to increase risk."

Of course, examiners keep track of bank operations for the very reason that deposits are insured. These examiners are adept at monitoring financial operations — even nonbank financial operations — but not as skilled when it comes to commercial ventures.

Reconsidering ILCs

All of these cautionary flags have been raised over the past few years as several large commercial firms applied to start or acquire industrial loan corporations. At present there are 61 ILCs, with 18 of those being owned by commercial parent companies. Many of them exist to serve the businesses of the parent companies, like BMW Bank of North America, which provides auto loans. (The Federal Reserve has no jurisdiction over ILCs, as firms can own them without the need for a bank holding company, which the Fed does regulate.)

Wal-Mart applied for an ILC charter in Utah in 2005, saying it intended mainly to use the powers in processing debit and credit transactions. The retailer recently withdrew its application after the FDIC declared a moratorium, which is now to extend into 2008, on ILC applications as the FDIC stepped back to study whether "there are emerging safety or policy issues involving industrial banks."

Some of the loudest protests to ILC expansion came from community bankers. In 14 pages of testimony this April, the chairman of the Independent Community Bankers of America, James Ghiglieri, spoke at length on the potential systemic risks that ILCs operated by the likes of Wal-Mart or Home Depot pose to the economy. It wasn't until page nine of his comments that Ghiglieri addressed a leading suggestion of why community bankers might oppose big ILCs: that they fear Wal-Mart will use its size to virtually take over some banking markets. In his testimony, Ghiglieri denied that implication.

"It would be absurd to assert that community banks seek to close the ILC loophole because they fear competition. Community bankers welcome competition," Ghiglieri says. "To suggest that community bankers are afraid of competition is uninformed, unwarranted, and only diverts attention away from the real policy issues."

But do community banks have anything to fear from Wal-Mart's — or any other large companies' — entry into their realm? According to a recent study, maybe not. Wal-Mart had bank branches in more than 1,000 of its stores as of 2006, with occupants including SunTrust and First National Bank of Texas. Researchers with the Federal Reserve Board of Governors recently studied how well those bank branches were performing. If they were doing very well, for instance, that might offer some evidence that allowing Wal-Mart into banking could eventually drive community banks out of business.

It turns out that, in terms of deposits, branches in Wal-Marts located in major metropolitan markets fare no better than other branches. However, banks that enter some rural areas with in-store Wal-Mart branches see an increase in their deposit market share relative to opening other branches. This suggests that banks in rural areas would be most likely to experience the strongest competition from Wal-Mart branches. Of course, these are branches of banks that are unaffiliated with Wal-Mart, so perhaps the efficiency gains that Ukrop's enjoys with First Market may not be in play in this study.

Wall-Power

Even with the wall between banking and commerce still standing, more and more businesses are finding ways to get into financial services, if not outright banking services. Cincinnati-based Kroger recently announced it would roll out personal-finance services throughout its 2,400 stores, branded under the Kroger name. Customers can obtain home-equity loans, insurance, and credit cards, among other offerings. Of course, customers still need to visit

an actual bank branch — whether in-store or not — to open a checking account. Wal-Mart offers its own credit card and has alliances with money transmitters and check cashers.

First Market's Fairchild is ambivalent about whether Wal-Mart should be granted full-fledged entry into banking, perhaps because of the same self-interests that all community bankers have about such a scenario. Wal-Mart's "colossal" size and ability to dominate markets poses problems that the Ukrop's-First Market combination doesn't, at least for now, he says. "Personally, I'm not sure I'd be an advocate to say let's break down the barriers to Gramm-Leach-Bliley. But there are situations where it could work and ours is one of them," Fairchild says. "It's kind of hard to make the leap that, gee, it works for us, couldn't it work for anybody else?"

Let us agree that the combinations of banking and commerce can pay dividends — for shareholders, customers, and possibly the economy at large. Equally, risks accompany these combinations, particularly with the potential for loss-shifting. For market-oriented economists, the banking and commerce wall is thus something of a puzzle. Instinctively, they are skeptical of regulations that might hamper the ability of the economy to function as efficiently as possible. But most accept the reality of deposit insurance and the stepped-up oversight that goes with it in the banking world.

The big question is whether the expected costs of expanding the safety net outweigh the expected benefits of allowing those combinations. Unfortunately, no conclusive empirical evidence exists on that question. So until then, many banking economists think that the wall should remain standing — just to be safe.

"I like to minimize the amount of the economy that has a government safety net under it," economist John Walter says. "I like restrictions that keep the safety net as small as possible, and this seems like one of them. For that reason, at a gut level, I'm against combinations of banking and commerce." **RF**

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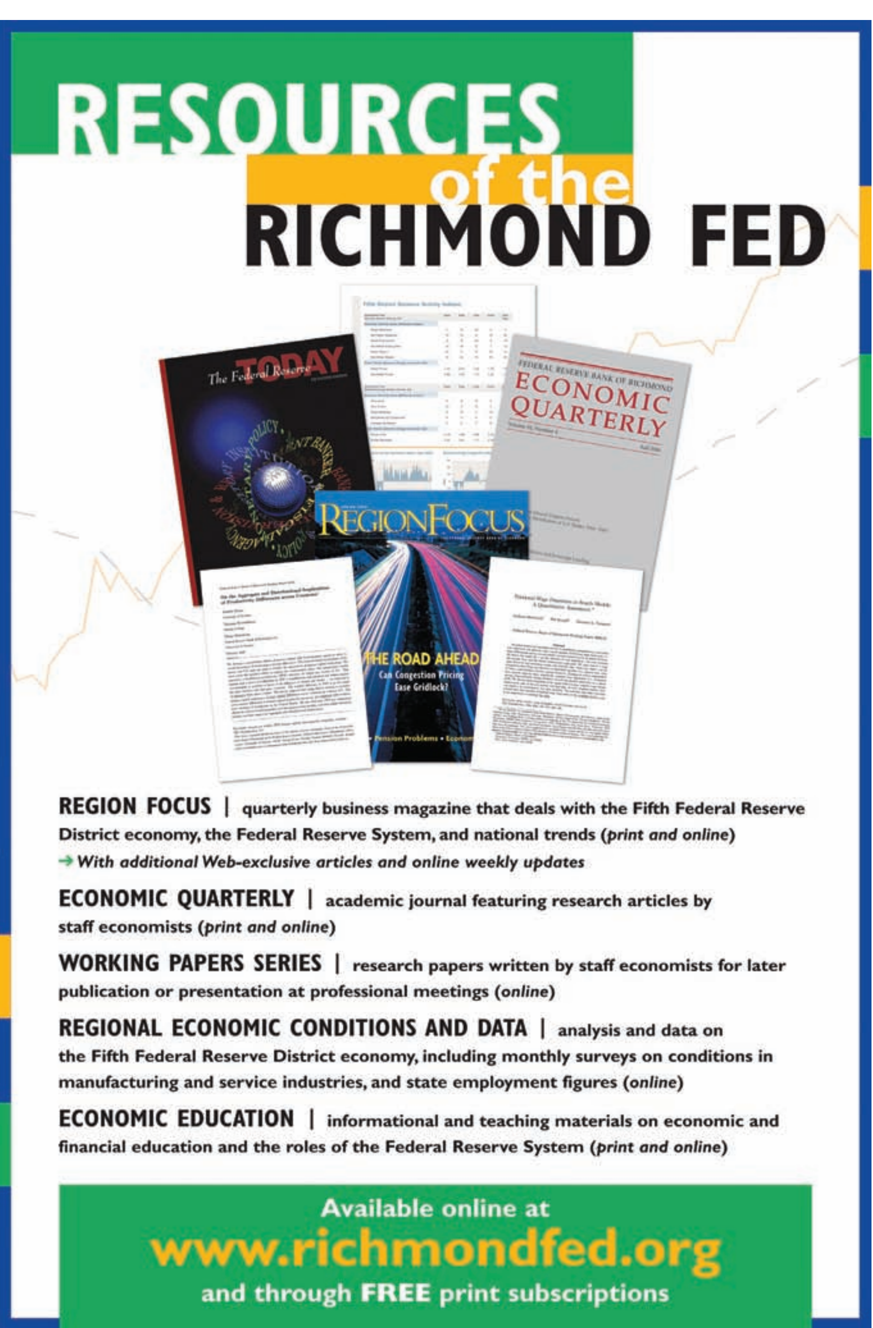

Interview

Russell Sobel

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

West Virginia has long been one of the poorest states, despite decades of government programs aimed at stimulating growth. In a new book, 25 scholars take the question of West Virginia's struggling economy head-on and offer a number of solutions — none of which have to do with state-run economic development programs. The book was edited by West Virginia University (WVU) economist Russell Sobel, who also contributed several articles.

A native of South Carolina, Sobel brought a unique free-market orientation to the book. His research has focused on ways to foster entrepreneurship, restrain government spending, and use tax codes to promote economic growth. He has also investigated government failures in disaster relief efforts, most recently with the response to Hurricane Katrina. Sobel's varied fields of inquiry have encompassed the implications of increased safety features in NASCAR and the preferability of the Articles of Confederation to the Constitution. His research has been published in the *Journal of Political Economy*, *Economic Inquiry*, and the *Journal of Economic Perspectives*, among other journals. He is also the co-author of a leading economics textbook, *Economics: Private and Public Choice.*

Sobel joined WVU's economics department straight out of graduate school in 1994. He served as founding director of the school's Entrepreneurship Center and now holds the James Clark Coffman Distinguished Chair in Entrepreneurial Studies. His classroom innovations, including the use of walkie-talkies in large lecture classes, have won him several teaching awards. Doug Campbell interviewed Sobel on the WVU campus in Morgantown on July 3, 2007.

PHOTOGRAPHY: TIM TERMAN, DIRECTOR OF COMMUNICATIONS, WEST VIRGINIA UNIVERSITY

RF: How did you come to edit the recently published book, *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It?*

Sobel: If you have a friend who is a medical doctor, when they go to parties they are always asked, "Hey doc, I have this rash. Can you look at it?" Being an economist in West Virginia is a lot like that, because our economy is just so horrible, not only in the level of per-capita income but also in growth statistics. This economy is just not doing very well, and it's on a lot of people's minds here in West Virginia. So I get asked all the time: "What can we do about it? You're an economist. What can we do to fix the West Virginia economy?" The problem is that it's not a one-sentence answer. I've been wanting for the longest time to put together some scholars to take a hard look at the policy questions in West Virginia to see how we could change our policies in order to help increase economic growth. We ended up getting 25 scholars from across the nation together, including an editor of a leading economic journal and some legal scholars. They analyzed different West Virginia public policies, like the tax code and the legal system, and we put their papers together in a book.

RF: Your assessment is that West Virginia's policies are largely to blame for the state's poor economic performance. A lot of people believe that natural resources and geography are the major determinants of economic growth. Why, in your opinion, is that notion mistaken?

Sobel: The best way to think about an economy is that everyone starts with some ingredients, some inputs to work with. Then you've got to bake those ingredients — that's what the institutions are, the way your economy is organized. Do you organize your economy based on markets or based on central planning? Comparing North Korea to South Korea is useful. They have the same inputs to work with, the same land, same climate, same population, and same history. But they have wildly different economic outcomes, and it's not due to differences in inputs. It's due to differences in the way they structure their economies. It's not to say the inputs aren't important, but what you can make from your inputs depends on the efficiency of the economy in which inputs are utilized. To make the most productive use of those inputs is key.

In West Virginia we've been dumping dollar after dollar at the state level into increasing education funding, building interstates, and all of these other inputs. But the problem is that we can't get the oven turned on so we keep throwing these inputs in there. We've got all these people now going to college who weren't before, but they're leaving the state after graduation and going to North Carolina and Virginia and other places. The problem is that investments in education are never going to pay off until the jobs are here for those people to take.

I'm not saying policies are responsible for everything that's wrong in West Virginia, but look and compare us to other similar states, and then growth rates speak volumes for how much of the difference is due to different policies. Charleston, W.Va., and Charlotte, N.C., 50 years ago had identical populations and identical per-capita incomes. Now Charlotte is 10 times the size of Charleston. Charleston is shrinking. North Carolina is a good comparative state because it lost much of its textile industry to foreign competition. It is very rural except for the Research Triangle and Charlotte areas. It's a similar kind of state that has experienced a lot of devastating things. But all economies experience devastating things. All economies go through creative destruction, where firms die and industries die. The key is to have an economy that's vibrant enough to replace those with new industries and new businesses. North Carolina has been very successful with that, especially Charlotte. Those banking headquarters didn't locate there because of something underneath the ground. They could have located anywhere. They could have just as easily gone to Charleston, W.Va., but they have a good business climate in North Carolina that attracts businesses.

RF: Which specific policies in West Virginia do you believe are most in need of reform?

Sobel: You need to look at our policies in West Virginia relative to other states. Our book goes into a lot of different areas, but if you look at taxes and the legal system, I think those are the two biggest barriers to growth in West Virginia. We levy very high taxes on capital investment in West Virginia, for example. One of the things I do with the book is show photos of the state border. MeadWestvaco, originally called the West Virginia Pulp and Paper Co., a Fortune 500 company, has a plant on the other side of the border in Maryland. That's billions of dollars in capital right there on the other side of our border, and when you're investing that much money, small differences in the tax code matter.

> I'm not saying policies are responsible for everything that's wrong in West Virginia, but look and compare us to other similar states ...

We have two taxes that hit capital investment very heavily here in West Virginia. There is a business franchise tax based on gross receipts, not profits; and we have a very high property tax on machinery, inventory, and equipment. It's so high, in fact, that when Toyota negotiated its plant in Buffalo, W.Va., the whole negotiation centered on having the state own all their equipment and lease it back to them. That makes them exempt from state property taxes because it's state-owned property. A lot of the local economic development agencies do the same thing. They own all the machinery and lease it back to firms so they can avoid the high taxes. Well, that's great if you're Toyota and can negotiate that. But if you're a small entrepreneur without a lot of political pull, what then? We've got a very heavy tax on capital investment, which is really a shame because capital investment is so critical for increasing labor productivity and getting people tools and machinery to work with, not to mention jobs.

Piece two of the puzzle is legal reform. We have lawsuit abuse. When you look at the legal climate rankings, West Virginia is at the bottom of those as well. One problem is venue shopping. We allow plaintiffs to pick which court they want to try their case in, so you can shop around for sympathetic judges. All the asbestos cases came here to West Virginia. We also have a problem with joint and several liability, which is when several people are negligent in different proportions for damage. Here in West Virginia, we sue both of them for 100 percent. Everybody tries to tag on Wal-Mart or a big firm to every lawsuit, someone with deep pockets. The firms here in West Virginia are sued a lot and they have very high legal costs.

Another problem is how judges are elected. About half the U.S. states appoint judges, and the others use elections, but only a handful of those do it on a partisan basis. When you run for a judgeship in West Virginia, you run as either a Republican or a Democrat on a political platform. Our last Supreme Court race was a good example: You had a Democrat saying, "If you elect me, I will decide cases in favor of labor," and a Republican saying, "I will decide cases in favor of businesses." In most states that elect judges, you run on your name and record. We have a very politicized legal system in West Virginia. So overall I'd say 80 percent of the problem is the tax code and our legal system. We also have some regulatory problems and we look at those in the book as well.

RF: You have written a number of papers on the economics of the Federal Emergency Management Agency (FEMA). Your analysis suggests that the failure of FEMA to respond effectively to Hurricane Katrina was wholly unsurprising. Why?

Sobel: Before Katrina, I wrote a paper with a then-graduate student, Tom Garrett, now at the St. Louis Fed. We were looking at the process for disaster declarations and the funding that's allocated for disasters when they occur. What we found is that, with the disaster declaration program, which is controlled by the president, all of the last five presidents had the largest numbers of disasters declared in their presidencies during their re-election years, their fourth years. They were also much more likely to declare them in battleground states. Last time, West Virginia was a battleground state, and I was joking that it was going to be a bad year for the weather.

Now, Hurricane Katrina was a no-brainer in terms of declaring it a disaster. But those kinds of storms are just a handful of the hundreds of disasters that are declared every year. The majority is for severe rain and windstorms, and they're a judgment call. So politics plays a huge role in terms of whether a disaster is declared or not. The second part is, given a disaster declaration, is there politics at play in terms of how much funding an area gets? We found that is the case. The funding is most influenced by congressional oversight. So if you have a representative on the FEMA oversight committee, then your area is likely to get more funding than if not. (This was before FEMA was moved under the Department of Homeland Security.)

We ended up doing four or five specific papers on what went wrong with Katrina and how we can reform FEMA to better handle natural disaster relief in the United States. Our research points to several things. One is the bureaucracy. In any government organization, the result can be something that Michael Heller called "the tragedy of the anti-commons," which is when too many people have veto rights, so it becomes hard to get permission to do anything and it slows down the process. That was the case with Katrina. Also, much like the FDA, which economists have criticized for being too cautious with approvals for new drugs, that same incentive seems to be at work with FEMA in that they were very cautious about allowing people into disaster zones, because if something happens to one person, then they are under pressure for letting that happen.

RF: What is the biggest problem you identified?

Sobel: It is that essentially what FEMA does in these disaster areas is it goes in and basically imposes central planning on the economic activity within the disaster area. For instance, Greyhound Bus Lines was willing to evacuate people from the Superdome for free. They kept calling and couldn't get an answer. If you want to go in and help in the disaster area, or if you're a demander in the disaster area who wants something, you have to go through FEMA. All these demands and supplies have to be communicated to the central agency and matched up. The day before Katrina hit, the Coca-Cola Company could deliver as much Dasani bottled water into New Orleans as it wanted without any special approval. But then all of a sudden bottled water is needed more than ever and Coca-Cola can't get into New Orleans because they can't get approval from FEMA to deliver the truckloads of bottled water they have. We need to separate out this aspect of economic activity, which is really that after a disaster, the fundamental problem at hand is a problem of getting resources into an economy and figuring out which resources are needed and finding suppliers and matching them up. That's what a market economy does really well, and we are basically shutting out that process in these natural disaster areas.

What we suggest would be much better is this: In a market economy, there is a fundamental role for government to protect individuals and their property to eliminate coercion and violence, to enforce the legal system, and to provide basic public goods such as infrastructure, roads, and those kinds of things. The government role after a natural disaster should be very similar to its role in the everyday economy. Its most important role is to go in and secure law and order and start repairing roads and bridges and infrastructure, providing the fundamental things that an economy needs to work with. But then it should let Coca-Cola and others in the private sector worry about the bottled water. There is no reason why they needed special permission. If the government wants to help with bringing in free bottled water, that's fine, let them support the process to help provide people in need with the things they need, but don't shut out private enterprise. We had a lot of men and women after Katrina ready to go in and give relief, and we need to use those talents to a much greater extent. The people in government aren't evil; they don't have bad intentions. They really want to do things right, but they don't have a fundamental knowledge of economics.

RF: Your research suggests that states fall into fiscal crises primarily because of cyclical downturns. Why don't policymakers ensure that rainy day funds aren't short during the inevitable times of need?

Sobel: I started my research on state fiscal crises while in graduate school. I became interested after the recession in early 1991, with fiscal crises everywhere. Along with my co-authors, I started looking at rainy day funds and wondered why most states ran their funds to zero very quickly during a recession. They simply didn't have the surplus built up in their rainy day funds to help them weather their recessions. Why do they have these things if they're not funding them, and how big of a role do they play in trying to ease the fiscal stress that's associated with recessions? What we found is that there is a big difference across states in their rules over these funds. Some states have rules and requirements on when money can be deposited and withdrawn from the account. With others it's just an account that the legislature can deposit or withdraw money from anytime it wants. Other states have it set up it so that withdrawals and deposits are based on how far your actual revenues are off from your forecasted revenues. That's what we have in West Virginia, so here you can only access the rainy day fund when revenues come in short of what was forecasted. Well, you could be in the middle of an economic boom and have revenues fall short of forecast and withdraw money out of the fund. On the other hand, you could be in a recession but you just happen to have accurately forecast revenues so you can't access the rainy day fund.

We asked whether these rules matter in terms of how much states are able to build up their funds and whether they're able to weather recessions without cutting spending and raising taxes. Sure enough, those states with requirements on deposits and withdrawing money were much more effective at building up the surpluses they needed to help them weather recessions. If you're going to have an unstructured rainy day fund, you might as well not have one.

RF: You argue that, in some ways, the Articles of Confederation were preferable to the Constitution. Could you briefly explain?

Sobel: One of the things I was very interested in was comparing the Articles of Confederation to the Constitution because of my dissertation research on the United Nations (U.N.). Almost every year a proposal comes up in the U.N. General Assembly to give the organization the power of international taxation. Most people argue, "No, we don't want to do that," because most prefer having their funding of the U.N. come from contributions from member states. The members give money or can withdraw themselves if they don't like what's going on. Ironically, that's exactly the system of financing our federal government had under the Articles of Confederation. The federal government did not have the power of taxation. It had a budget allocated across the states, and the states then raised the money and sent it to the federal government. When we moved to the Constitution, we gave the federal government the power of taxation. Some of my research has looked into this contribution mechanism of financing government. I think it has a lot of potential to really promote economic efficiency and good government.

It transfers a lot of power back to the states and decreases centralization. You get a lot more control over your federal government. Like with the U.N., member states can say they'll take their money elsewhere unless it's reformed. So it served as a constraint on the federal government when the states had that ability. More interestingly, it puts state-level intergovernmental competition to work in raising federal revenue. You can have the same size government, federal and state, as you do now with the other mechanism. But it's just that instead of the federal government collecting one-size-fits-all taxes across all states — right now we have the same federal income tax rate in all states and the same types of federal taxes in all states — it may be that in West Virginia the revenue would be more efficiently raised by taxing natural resources. Or maybe the optimal tax rate here isn't the same as in California. So it puts that intergovernmental competition to work in raising federal revenue.

We found that during the Civil War, the Confederate States of America experimented with a similar mechanism, where they levied a property tax on the Confederate states

Russell S. Sobel

Present Position

James Clark Coffman Distinguished Chair in Entrepreneurial Studies, West Virginia University

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Education

B.B.A., Francis Marion College (1990); M.S., Florida State University (1993); and Ph.D., Florida State University (1994)

Selected Publications

Co-author of the economics textbook, *Economics: Private and Public Choice* (2006). Co-author and editor of *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It* (2007). Author or co-author of dozens of academic papers, including "Automobile Safety and the Incentive to Drive Recklessly: Evidence from NASCAR" (2007); "The Political Economy of FEMA Disaster Payments" (2003); and "Theory and Evidence on the Political Economy of the Minimum Wage" (1999)

Awards

Kenneth G. Elzinga Distinguished Teaching Award, the Southern Economic Association; and June Harless WVU Teaching Award

and allowed states the option of submitting the revenue to the national government. If the state submitted the revenue, then they would not levy the tax in that state. And all but one state opted to do that. The states were given the option to levy the taxes in alternative ways to a property tax to raise that money, and the Confederate government got all the money it wanted.

The nice thing about that structure is it overcomes the free rider problem. People worry in contribution systems about scenarios like — what if California doesn't pay? Well, the nice thing about the Confederate solution was that if the state didn't submit the money, then the national government could go in and levy the taxes and collect them itself. In a hybrid model that I proposed in a paper, the states could elect to submit to the federal government the revenues that would replace the federal income tax burden on West Virginia. If we wanted, we could levy that as a sales tax and do away with the federal income tax in West Virginia. That's one of the favorite issues I've worked on, but certainly relative to FEMA and state policy research that may have an impact, I doubt this will have an impact.

RF: Many people believe that Wal-Mart causes significant harm to the small, "mom and pop" business sector of the economy. Is that consistent with your empirical findings?

Sobel: This idea came up when I was directing the entrepreneurship center here at WVU. People kept saying, "How can we compete with the big-box stores like Wal-Mart?" Certainly, we see in those communities where Wal-Mart moves in, that stores go out of business. Wal-Mart beats small businesses that are competing in direct lines of merchandise. But here in Morgantown, some years after Wal-Mart came, all those storefronts are filled today by new and different things — by law offices, antique stores, and so on. They fill those same storefronts that were once things like general merchandisers, building suppliers, and hardware stores. The creative destruction process has replaced those things with new ones, and many of those new things aren't even retail. Yes, Wal-Mart creates failures. But with Wal-Mart, we all save money so we can spend money on more things. We have new small businesses pop up. The question I was interested in was, when looking at aggregate measures of small business in the economy today, has that sector been influenced by the influx of Wal-Mart stores?

We looked across states at the relationship between Wal-Mart stores and the size of the small-business sector along several different measures — sole proprietorships, firms with one to four employees, and even firms with five to nine employees. Through time we found that there was no effect in either direction relative to Wal-Mart. There are just as many small businesses today in the United States as there were when Wal-Mart was just one store in Arkansas. Some states have a lot of Wal-Marts per capita and other states few, sometimes because state laws have kept them out. But we don't see a much-larger proportion of small businesses in states that have kept Wal-Mart out. So the conclusion of our research seems to be pretty clear: that today's small-business sector has not been, as a whole, handicapped by the presence of Wal-Mart. In fact, it's just created reallocations within the small-business sector.

Now, people say, "Of course, there are still small businesses but they're worse," that somehow they're not as good. We looked at average revenues and profits of small businesses and can't find an effect there either. So this is a case we came at with the question of what did the data say, and interestingly enough, the data say zero. This is a case where we just can't find an impact, either positive or negative, on the size of the small-business sector. It doesn't mean that Wal-Mart doesn't cause certain small businesses to fail. But if you're someone in the Small Business Administration promoting small-business activity in the United States, our research clearly suggests that Wal-Mart should be the least of your worries.

RF: Can you briefly explain how NASCAR drivers have responded to safety improvements in their cars?

Sobel: In the economics literature, the root of all this is Sam Peltzman's argument in 1970 that safety improvements in automobiles would lead to more reckless driving and therefore would have some secondary effects that would offset the positive effects from the safety features. It's been more than 30 years since that article was published and people have been looking for these effects. The problem is that most of the data are state level and they are hard to use, because, for example, we have snow in West Virginia that causes more accidents. You can't control for everything, and you can't control for compliance as to whether people are wearing their seatbelts. So it's a problem in looking at measures and trying to find the existence of the Peltzman effect. The day I came up with the idea, I was teaching my principles of economics class and was talking about the famous example that is usually attributed to Gordon Tullock: that a dagger placed in the middle of the steering wheel, eliminating the seat belt, would cause people to drive more safely. I always wished I had the opposite. What do people do when cars are really safe? And then it came out of my mouth: When cars get so safe that you can flip them and roll them over and walk away without a scratch, people drive them at 200 mph on a little round track inches away from each other.

What I wanted to do was go back and look at NASCAR. A graduate student of mine was a big NASCAR fan. He collected all the data. It's an ideal environment to test this in because there are so many things we can't control for in the real world that are already controlled for by NASCAR. For example, they don't race in the rain. You know they are all complying and we can actually measure how reckless people drive, how many wrecks there are or how many cautions, and we can measure what the true odds of getting hurt are. Going way back in NASCAR history the cars were not all that safe. In the early road races there were guys in convertibles with motorcycle helmets. So safety has been increasing

and we can measure what the conditional probability of injury is, what the odds are of getting injured or killed, for every year. The simple question we look at is, as these cars have become safer, given that drivers are much less likely to get injured or killed today than 20 years ago, what effect has that had on measures of reckless driving and accidents within NASCAR? We find that, no matter how you measure it, there have been increases in accidents as cars have become safer in NASCAR. We even took a subsample of the five to 10 drivers who were there throughout the entire history and just looked at their behavior and found that they got into more accidents as their cars became safer.

Of course, the reason why is they want to win races and you've got to take risky maneuvers to win races, to pass other cars. We find very strong support for the Peltzman effect in NASCAR. But if those effects are big enough, you could end up with safety improvements causing more harm than good. Luckily, we didn't find that large of an effect. In fact, it seems like a win-win. As you make the cars safer in NASCAR we do end up with more accidents. Fans like to watch races, in part, for the accidents, and we are getting more of them, but fewer drivers are getting injured because the safety improvements have been so large.

RF: By extension, can we assume that, on average, today's everyday motorists are also driving more recklessly because they are behind the wheels of safer cars?

Sobel: It's an interesting question. We certainly can demonstrate it exists in NASCAR, but a NASCAR driver might be different in a lot of ways from the average driver. They might be more risk-loving than the average driver. But there are possible similarities. If you're a NASCAR driver, you're making a choice to take a maneuver that will save you time to get you ahead, and the reason for doing that is to win the race. Every day on my way to work, I've got a goal, which is to get to work quickly. So when I'm on my way somewhere in the car, I've got the same choices in terms of cutting in between cars or running a yellow light. In a very fundamental sense, the marginal decisionmaking is the same in those two instances.

RF: You've used walkie-talkies as a way to increase classroom participation. How did you come up with that idea and has it worked?

Sobel: When I got here and started teaching large lecture classes, I wanted to find a way to increase class participation. One day when a teaching assistant was giving the lecture, I sat in the back of the class. Lo and behold, I could hear talking all around me, and they were talking about economics and leaning over and asking me questions. I realized that people in the back of the room really do want to talk to me and ask questions. It's much harder, though, when you've got to stand up and yell out in front of 300 students to get those answers. So I came up with the idea of using walkie-talkies. When I suggested it to my department chair and my wife, they laughed at me. I went to Radio Shack and got some cheap walkie-talkies and passed them out in the class. Then I took one of them and put it up as a podium microphone, so that anything said over any one of the walkie-talkies comes out over the speaker system just as loud as my cordless microphone. I started experimenting and passing them out and, sure enough, the students loved them. The process evolved and pretty much now in all my large lecture classes I give out walkie-talkies every day. They have numbers and then I say, "OK, who's got walkie-talkie number 1," and then talk to them for a minute and learn their name and find out a bit about them. I call on them for examples. The people with walkie-talkies, even on days when they don't take them, are now much more likely to speak because they have stood up and spoken to me before. The interesting part of it is getting to know my students and making them feel like I care about their participation, and getting input on the class. I talk very fast so I let them use a beep button to pause me. It's not high-tech but it's been very successful and helped me win some teaching awards. I used the award money to buy new walkie-talkies.

RF: What are you working on now?

Sobel: I was watching "Law and Order" with my wife and the episode was about the district attorney (DA) being up for re-election. What happened is that someone confessed to a crime, but as a viewer you're thinking that they didn't really do it but they just got pressured into confessing because they wanted the conviction before the DA's re-election. So I started wondering if that really happens, because that's an issue of whether the political process of elections plays a role in the outcomes of our legal system. The innovation of our paper is that we were able to actually find the timing of these DA elections. The question remained: How do you measure false confessions or false convictions? After a year of thinking about it, I found the ideal data set. There are several programs, such as the Innocence Project, that look at questionable cases from the past and use DNA evidence to free people wrongly convicted. They have now freed 500 to 1,000 people scattered throughout history based on overturning those convictions with modern DNA evidence. What we're doing is going back and looking at all the cases overturned, looking at the distribution of the timing of the original conviction — for example, what month of the year and was it near an election. We have found that Octobers of election years have more than four times as many convictions later overturned as any other month of any other year in the data. The people from the Innocence Project say they don't look at timing at all, they just pick the cases based on merit. So you'd expect this to be a randomly scattered distribution throughout months of the year looking at original dates of conviction. What we're finding is that there are some incentives at play to get convictions around election time. The Duke Lacrosse case is relevant because that happened right around that DA's election. **RF**

Going to Market

BY CHARLES GERENA

Although furniture production has declined in the Piedmont region, buyers and sellers still flock to High Point, N.C.

"Furnitureland, U.S.A." isn't a theme park, though within its confines you can find "the world's largest chair" and two larger-than-life dressers, each built onto the edifice of a building. Rather, it's a region in the Piedmont of North Carolina and Virginia that once produced more than half of the nation's wooden bedroom and dining room furniture.

Using a series of interconnected highways roughly shaped like a figure eight, a retailer looking for the latest home furnishings could visit dozens of North Carolina manufacturers in small towns whose names are synonymous with high-quality furniture — Lexington, Thomasville, Hickory, Drexel, Lenoir, and High Point, where a trade show has been held since 1909.

The High Point Market transforms every nook and cranny of the city for one week every spring and fall. Furniture makers exhibit their latest offerings in 12 million square feet of showrooms scattered throughout downtown. Last March, an estimated 85,700 buyers and sellers from around the world came to High Point, almost doubling the city's estimated population of about 97,800.

Twice a year, tens of thousands of buyers and sellers are brought together in showrooms scattered throughout downtown High Point.

PHOTOGRAPHY: HIGH POINT MARKET AUTHORITY

The High Point Market also brings money — an estimated $1 billion — into the regional economy annually. About two-thirds of that money is spent on the construction, renovation, and decoration of furniture showrooms. The remainder goes to local restaurants, hotels, retailers, and transportation providers.

Why do so many people cram into this small city twice a year? When Southern manufacturers became prominent players in the furniture industry after World War II, their regional market was located in High Point because it provided a central place for buyers right in their backyard. "It was a market of convenience for manufacturers," says Wallace "Jerry" Epperson Jr., furniture analyst and managing director of Mann, Armistead & Epperson in Richmond.

Once High Point gave retailers what they wanted, its furniture market expanded in scope and eventually stole the international spotlight from Grand Rapids, Mich., and other centers of furniture marketing in the Northeast and Midwest.

Today, the geographic ties between manufacturers and the High Point Market are much looser. Furniture production has gone overseas and it isn't as prominent in the Piedmont. Other cities have tried to steal the spotlight from High Point. Las Vegas is the latest contender, using the lure of spanking new showrooms along with its plentiful supply of hotels and entertainment options. Yet High Point remains the largest trade show for the furniture industry in the United States.

"What really makes it unique is the breadth of merchandise" available to buyers, Epperson notes. He and other observers believe it would be difficult for another regional market to reach this critical mass. "High Point has evolved over the last 90 years into

what it is today. Las Vegas' [market] began in 2005."

The Need for Trade Shows

In an era of instant electronic communications, there is still value in the one-on-one interactions provided by trade shows like the High Point Market. By putting lots of buyers and sellers under one roof, they facilitate the exchange of ideas and market knowledge. They also reduce search costs — instead of companies sending out salespeople to chase down leads, interested buyers come to them.

This is especially important for furniture manufacturers. Since their product is large and bulky to transport, sales representatives are usually stuck with showing photographs or catalogs to potential customers. In the past, they carried miniatures to show off their company's workmanship.

"[Buyers] want to sit in the sofa, feel the fabric," says Harley "Buck" Shuford, former president of Century Furniture in Hickory, N.C. "I wouldn't want to buy a sofa without sitting in it."

Trade shows also help fill a vacuum in the distribution of furniture. The industry doesn't have an extensive network of wholesalers to serve as middlemen between retailers and manufacturers. Instead, they deal directly with each other or, in the case of a few companies like Ethan Allen and Ashley Furniture, producers sell directly to consumers.

Marketing has always been a challenge for furniture producers. In the 1870s, several Grand Rapids companies chartered railroad cars to carry their products from town to town for buyers to examine. A salesman or executive from the company would entertain customers and take orders as the car stood on a rail siding. Earlier, Boston manufacturers took their products to neighboring towns by boat, holding auctions at dockside.

Furniture manufacturers in New York and other parts of the Northeast began using warehouses to cooperatively market their products during the 1880s. Still, "buyers had to go from one small display to another at great expense and inconvenience," wrote David Thomas in a 1967 article on the furniture industry. Eventually, producers recognized the need for a better marketing vehicle and discussed creating a general exposition where they could show their products to a large number of buyers simultaneously.

During the summer of 1891, the first New York furniture market was held in an 89,750 square-foot building in Manhattan's Upper East Side. It attracted more than 1,000 buyers and 79 exhibitors over a four-week period.

Traditionally, furniture markets have formed near centers of production. As manufacturers clustered in certain regions to tap into new supplies of lumber and labor, new markets were created to link buyers and sellers.

The first market in 1874 was held in Boston since many producers were located in New England. Later, Swedish furniture makers that clustered around Jamestown in western New York and Dutch furniture makers near Grand Rapids held their own markets. Several exposition buildings went up in Chicago between 1896 and 1924 to reflect that city's emergence in the furniture industry.

North Carolina manufacturers also attended the furniture markets in New York, Grand Rapids, and Chicago. Though they had mass-produced furniture since the 1880s, it would take several decades for them to form a market of their own.

The Early Years

Furniture had been made in North Carolina as far back as the 1700s. Craftsmen who immigrated to the Tar Heel State used the skills and tools they brought with them to transform oak, cherry, maple, and other native hardwoods into fine handmade chairs, tables, and beds. Only limited quantities of furniture were made and only for local consumption.

But by 1900, 44 plants churned out furniture in North Carolina, many of which had their own showrooms. More than a dozen of these large-scale, mechanized factories were located in High Point, making it a natural location for Southern manufacturers to market their goods centrally.

A small showroom was financed by a group of High Point's leading producers in 1905. Another larger showroom was opened by a rival exposition company in 1906. For three years, both facilities stayed open year-round to entertain the buyers who occasionally visited High Point. Then, the two companies joined forces to stage a trade show to rival the big events in New York, Chicago, and Grand Rapids. The first formal furniture market in High Point was held in March 1909, followed by a second event in the summer.

Both shows failed to meet people's lofty expectations and plans to hold a biannual market were scuttled. "Southern production of furniture had not by that time reached a level high enough to attract buyers in large numbers" to a regional market, David Thomas noted in his article. The establishment of such a market "was a vast undertaking for a producing center only 20 years old." Instead, individual manufacturers continued to display goods at their factory showrooms and in exhibition spaces throughout High Point as their business continued to grow.

The idea of a large formal market came up again four years later. High Point manufacturers chipped in $2,000 to hold the Southern Furniture Exposition in showrooms scattered throughout eight buildings. For a little more than two weeks during the summer of 1913, the exposition attracted about 100 exhibitors from throughout the South — mostly from North Carolina — as well as a few Northern producers. But the attendance of 300 to 400 people was below projections. Another exposition took place in January 1914 with similarly disappointing results. World War I put future events on hold as furniture production shifted to satisfying wartime needs.

In 1919, Southern furniture manufacturers tried again to capture the industry's attention. This time,

the Southern Furniture Exposition Company purchased property on South Main Street and invested $1 million to build a permanent exhibition center two blocks south of the railroad station. The building opened in June 1921, presenting the wares of 149 manufacturers in 249,000 square feet of showrooms.

By the end of that month's market, 700 buyers from 100 cities had placed more than $2 million in orders. This success was, in part, attributable to the wider variety of grades and price points available from Piedmont furniture producers in the 1920s.

Over the next decade, High Point's trade show became known as the Southern Furniture Market. It remained primarily a regional event, though department stores like Macy's and Marshall Fields sent representatives and most of the country's furniture-producing centers put some goods on display. The growth of the market's breadth and depth reflected the continued expansion of the furniture industry in North Carolina and elsewhere in the South, while the industry itself benefited from rising incomes and booming home construction nationwide. By 1931, about two-thirds of Southern furniture was sold in other regions.

The World Comes to High Point

The Great Depression interrupted the furniture industry's growth. In High Point, attendance at the Southern Furniture Market fell in the early 1930s as manufacturers went bankrupt or consolidated.

The market recovered with the economy in the latter part of the decade. More buyers stopped in High Point on their way to or from the larger markets in Chicago, New York, and Grand Rapids. Not only did Southern manufacturers give them more of what they wanted — North Carolina and Virginia accounted for about one-third of all bedroom and dining room furniture made in the United States by 1937 — but it was easier to get to High Point due to enhancements in rail and road transportation. The result was a record-setting 2,485 buyers crowding the Southern Furniture Exposition Building in 1936, the facility's 15th anniversary.

The regional market in High Point was suspended during World War II. It didn't reopen until January 1947.

In the meantime, people began to worry about losing the market to another Southern city. A May 7, 1945, editorial in the *High Point Enterprise* discussed the possibility of the market moving to Atlanta or Roanoke, Va. Buyers were complaining that High Point was a "hick town" where there was nothing to do but stay cooped up in a hotel. Atlanta also had more entertainment choices and hotel rooms than High Point at the time. The editorial's writer suggested that the city boost its entertainment offerings by staging a golf tournament, a nightly cabaret show, or other events during market season.

Despite these fears, the first postwar Southern Furniture Market drew 5,000 buyers from 34 states, almost double the number expected. Attendance grew to 6,500 in 1950, thanks in part to a 10-story addition to the Southern Furniture Exposition Building.

The regional market continued to be held every January and July, the same months as the larger furniture trade shows in Chicago, Grand Rapids, and New York City. In addition, a growing number of buyers visited Southern manufacturers in between these selling periods, prompting producers to maintain permanent exhibition space. Producers eventually held informal showings every April and October.

Roy Briggs, a furniture consultant who has attended every furniture market in High Point since 1936, recalls this period in the market's evolution. In the late 1940s, Burt Tuxford, a salesman for Drexel Furniture, started getting complaints from the large department stores that were his key customers. The July markets gave them little lead time in advance of their traditional August promotions for new furniture lines.

Tuxford invited buyers to see his company's products at its factory in April, Briggs continues. They could ask for different handles or other design changes and have their orders filled. At first, Macy's, Bloomingdales, and a few other retailers accepted Tuxford's offer. Eventually, most of the major buyers started coming in April instead of July. While they were in town, they would stop at other firms nearby.

Feeling bypassed by High Point's informal markets, Chicago began holding spring and fall markets in 1955. In response, the organizers of the Southern Furniture Market set dates for the April and October gatherings the following year. This expanded their formal market to a quarterly affair until the January and July editions, which declined in importance, were discontinued in 1982.

Despite resistance from some furniture makers, the spring and fall markets grew in importance during the 1950s and '60s. Department stores wanted a first look at the latest designs since they had to plan and purchase their goods well in advance of their traditional August and February sales. A broad range of producers from around the country came to High Point to do business with these stores and other buyers.

Foreign buyers and producers also started attending the markets. This reflected the globalization of the furniture industry as a whole, facilitated by the introduction of containerized shipping in the 1950s.

Interest waned in other furniture markets. Grand Rapids held its last market in 1965, while Chicago and New York markets lost their "big show" status. Articles published by the *High Point Enterprise* in October 1960 captured the changing preferences of buyers. "Chicago has become no more than a courtesy call for our buyers," noted an executive from a small department store chain in Milwaukee. "I don't go to Chicago anymore. Everything I need is in the South," said another buyer from Massachusetts.

Indeed, market timing was only one factor behind this shift in preferences. Furniture manufacturing in North Carolina continued to expand in volume and scope, yielding distinctive, stylish pieces that matched the quality of Northern manufacturers. "Southern firms literally leaped a giant step from a small regional industry to one selling nationally," noted Isadore Barmash, editor of *Home Furnishings Daily*, in an Oct. 24, 1960, *Enterprise* feature. Additionally, some Northern producers opened plants in the South to tap the cheaper, nonunionized labor force.

In 1989, the event was renamed the International Home Furnishings Market to reflect its role in the global furniture industry.

Now What?

Today, High Point hosts *the* trade show for the furniture industry, but it's not the only one. Buyers and sellers gather at regional markets throughout the United States, including Atlanta, Chicago, Dallas, Las Vegas, New York, San Francisco, Seattle, and Tupelo, Miss.

Overseas, regional markets are held in Birmingham, England; Guadalajara, Mexico; Tokyo, Japan; and Dubai in the United Arab Emirates. Cologne, Germany, attracted 115,000 visitors to its furniture trade show last January, but 34,000 were from the general public so it's still slightly smaller than High Point's business-to-business-only event.

Srinath Gopalakrishna, a marketing professor at University of Missouri-Columbia, explains why there are so many trade shows. Producers may send their best salesmen to smaller regional shows because they are more likely to meet up with their local customers and less likely to be overlooked. At the same time, an international show like the High Point Market can demonstrate a producer's prominence in an industry.

Before Buck Shuford retired from Century Furniture in the 1990s, the company operated showrooms in Dallas, Chicago, and San Francisco in addition to High Point. It was an added expense for Century, but "there were a certain number of customers who didn't want to come to High Point," Shuford says. Some local retailers prefer to attend the regional shows that are the closest to them in order to save time and travel expenses. Also, "a lot of retailers do business with a limited number of resources. They don't feel the need to look at hundreds of potential resources in a big market."

Nevertheless, High Point remains a leading choice for most major furniture manufacturers. Attendees still complain about the lack of hotel rooms during market season — they often rent houses from residents or stay at hotels as far away as Charlotte. The nearest airport, Piedmont Triad International, serves fewer cities and has far fewer flights than other airports in North Carolina. And High Point has never had a happening nightlife. But showroom space in High Point is about one-third to one-quarter of the cost of space at the emerging Las Vegas Market, according to Greensboro-based furniture industry consultant and blogger Ivan Saul Cutler.

This may give High Point an edge over Las Vegas, which drew more than 60,000 people to its 3.5 million square feet of showrooms last winter. "They have nice facilities and a lot to offer that High Point doesn't have," Shuford admits. But he doesn't think Las Vegas will become a competing national market because showroom space is more expensive. "You get twice as much space for a lot less money in High Point."

On the other hand, the Las Vegas Market is held several months earlier than the High Point Market, giving buyers the same advance access they enjoyed when coming to High Point instead of Chicago decades ago. Some furniture manufacturers have responded to this trend by keeping their High Point showrooms open all year long.

Furniture manufacturers have spent much of their careers and millions of dollars in High Point. That's no guarantee some won't opt for the glitz of Las Vegas in the long run, however. Last spring, the High Point Market drew 14 percent fewer attendees than spring 2006, the first time that market organizers used a central registration system to obtain an accurate headcount. Meanwhile, the estimated attendance at the last Las Vegas Market was 20 percent above the average attendance for the previous three shows. And, Vegas' furniture showroom space could match High Point's 12 million square feet by 2013.

Given the pressure on some buyers and sellers to attend fewer trade shows, some observers believe the industry may end up with two major markets: one in High Point to serve the East Coast and one in Las Vegas for the West Coast. In the meantime, the High Point Market fights an increasingly competitive battle to keep its status as the world's preeminent furniture trade show. **RF**

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Why Countries Default

BY DOUG CAMPBELL

"The Economics of Sovereign Defaults." Juan Carlos Hatchondo, Leonardo Martinez, and Horacio Sapriza. Federal Reserve Bank of Richmond *Economic Quarterly,* Spring 2007, vol. 93, no. 2, pp. 163-187.

Nations have been defaulting on their debt for ages, and recent history has certainly seen its share. Sovereign defaults peaked at $335 billion worldwide in 1990 before easing through the early 1990s. Then began a new string of problems as Russia defaulted on billions of dollars of debt in 1998, roiling global markets. Argentina's default of $82 billion was one of the largest recorded episodes in history.

In a new paper published by the Richmond Fed, a trio of economists survey the vast literature on sovereign defaults and conclude that even though there has been progress in the understanding of the economics of sovereign default, much remains unknown. Specifically, the precise costs that nations weigh in deciding whether to default are not well understood.

There is a consensus about what could be the main determinants of default episodes. Changes in external circumstances, such as unfavorable movement in international capital markets, can make it difficult for emerging countries to borrow at acceptable rates and terms. Changes in internal circumstances, such as declines in tax revenues during cyclical downturns or a change in political circumstances, may also trigger a default decision.

The big debate on sovereign defaults centers on identifying the costs associated with a default decision. Some analysts believe that creditors impose higher borrowing costs on nations that default. But the authors point out that this would require an unlikely degree of coordination among lenders in a time when international markets have evolved to the point where "almost anyone" can buy sovereign bonds. Also, the notion that defaulters are excluded from borrowing markets does not seem to be supported by empirical evidence. Finally, there may by "signaling costs" associated with a default. For instance, a default may signal that the policymakers in office are less prone to respect property rights or it may signal that the prospects of the economy are worse than what investors previously perceived. Though signaling costs seem plausible, the importance of this mechanism is unclear, the authors conclude.

Of particular interest to the authors are the political factors that drive default decisions. Some research has found that changes in top policymakers — such as among finance ministers — affect interest rate spreads, revealing "important signals about the government's future policy course." It is widely assumed that Argentina's 2001 default was driven in large part by political ousters. In an upcoming paper, the same authors try to extend these insights about political factors in default episodes. They develop a model in which policymakers of different types alternate in power. They find that the model may help explain both the high and volatile nature of interest rates in emerging markets.

"The Role of Small and Large Businesses in Economic Development." Kelly Edmiston. Federal Reserve Bank of Kansas City *Economic Review*, Second Quarter 2007, vol. 92, no. 2, pp. 73-97.

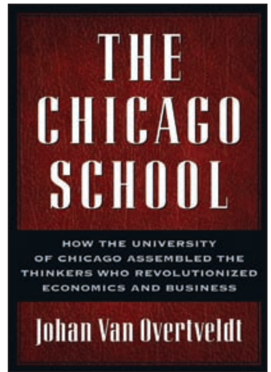
With "smokestack chasing" increasingly out of favor, communities are looking to pour their resources into a different sort of economic development effort: cultivating entrepreneurs and encouraging existing businesses. Kansas City Fed economist Kelly Edmiston argues that economic developers are shifting their strategies to focus on small and local businesses. In this paper, she questions the effectiveness of this approach and ultimately finds that it makes sense but with some caveats.

"Small businesses may not be quite the fountainhead of job creation they are purported to be, especially when it comes to high-paying jobs that are stable and offer good benefits," Edmiston writes. At the same time, small firms create the majority of new jobs and are important innovators in the economy. With recruitment of large enterprises unlikely to be cost-effective or successful, "concentrating on organic growth, or the growth of existing or 'home-grown' businesses, is likely to be a much more successful strategy."

"Anxious Workers." Rob Valletta. Federal Reserve Bank of San Francisco *Economic Letter*, June 1, 2007, no. 2007-13.

Unemployment is low, output is high, and jobs are plentiful. So why are American workers so worried about keeping their jobs? The dynamism of the U.S. economy raises living standards, but it leads to a constant churning of workers and firms.

Robert Valletta of the San Francisco Fed digs into job tenure statistics and discovers some plausible reasons for worker anxiety. Median job tenure has been falling since 1983 for most workers, except for women aged 35 to 54. Median tenure fell 30 percent for men aged 35 to 44 and 38 percent for men aged 45 to 64, or from 12.8 years to 8.1 years for this latter demographic. Meanwhile, firms are permanently laying off workers with more frequency, even highly educated workers. These findings, the author concludes, "lend credence to the view that worker anxiety about job stability and security is real rather than illusory." **RF**



Sweetwater's Capitol

THE CHICAGO SCHOOL: HOW THE UNIVERSITY OF CHICAGO ASSEMBLED THE THINKERS WHO REVOLUTIONIZED ECONOMICS AND BUSINESS

BY JOHAN VAN OVERTVELDT
EVANSTON, ILL.: AGATE PUBLISHING, 2007, 360 PAGES

REVIEWED BY AARON STEELMAN

Economists sometimes make the distinction between "Sweetwater" and "Saltwater" schools. The names come from the geographical locations of the universities and the economists who work at them. For instance, the Saltwater schools tend to be on the East or West Coasts, and include Harvard University, the Massachusetts Institute of Technology, and Stanford University. Saltwater economists often question whether consumers are really as rational and foresighted as standard neoclassical models suggest, tend to believe that market failure is relatively common, and hold that government intervention can sometimes help the economy perform more efficiently. Sweetwater economists, in contrast, tend to be located at universities near the Great Lakes (or the Middle Coast, as some call it). They generally believe that people act in their best interests and that, overall, markets do a fine job of allocating resources. State involvement, in their view, often is far more harmful than helpful. Leading Sweetwater schools include the University of Rochester, the University of Minnesota, and above all, in the public's mind and probably in most economists' as well, the University of Chicago.

In his new book, Johan Van Overtveldt, director of the Belgian think tank VKW Metena, aims to tell the story of how the Chicago School of Economics came to be — and the characteristics that have defined it over time and continue to define it today.

Overall, Van Overtveldt succeeds. He provides an informed, readable, and concise overview of the University of Chicago's contributions to economic science. It's clear that he has done his research — possessing an impressive command of the major articles, books, and texts produced by Chicago economists as well as having conducted more than 100 original interviews, many with the school's major figures. His account is clearly sympathetic but far from sycophantic.

One of the strengths of the book is that it does not treat the Chicago School as monolithic. Just as the Sweetwater versus Saltwater distinction is too simple — there are, for instance, many Sweetwater-oriented economists working at Saltwater schools and many Saltwater-oriented economics departments at Midwestern universities — the University of Chicago is not and has not been home to only doctrinaire free-market economists. The socialist Thorstein Veblen, author of *The Theory of the Leisure Class*, was arguably the first economist famously associated with the university. Henry Simons published a book during the Great Depression titled *A Positive Program for Laissez-Faire* that would hardly be recognized as such by today's profession (though, to be fair, at the time of writing, many of his ideas did seem distinctly pro-market). Lloyd Metzler, a prominent faculty member during the 1940s and 1950s, argued passionately for a generally Keynesian approach to macroeconomic analysis. And, today, Richard Thaler at the Graduate School of Business is one of the most important proponents of "behavioral economics," which questions the rationality assumption that has been so central to the work of many Chicago economists, including, of course, Milton Friedman and, especially, Gary Becker, who has used price theory to explain numerous aspects of human behavior once believed to be beyond economic analysis. In addition, Thaler, with Cass Sunstein of the Law School, has argued passionately for "libertarian paternalism," which other economists at the university have argued is a contradiction in terms.

Also, Van Overtveldt provides a strong argument that there really was no identifiable "Chicago School" until the 1950s. While many famous economists were associated with the university prior to then, it was the arrival of Friedman and, later, George Stigler that made Chicago stand out from its peers in its methodological and policy orientation. The addition of Becker and Richard Posner to the faculty in the late 1960s accelerated this trend. (Becker, it is important to point out, holds appointments with both the Departments of Economics and Sociology and Posner is at the Law School. The University of Chicago has a long tradition of multidisciplinarity, and the work of its economists is no exception.)

Van Overtveldt is to be applauded also for providing useful overviews of less widely known but eminent figures in the Chicago tradition, including Aaron Director, Sherwin Rosen, Eugene Fama, and Arnold Harberger — whose work in the economics of law, labor, financial markets, and public finance, respectively, did much to advance a generally free-market approach to those fields. (While it is correct, as Van Overtveldt points out, that not all Chicago economists have been ardent supporters of relatively unfettered markets, there is certainly more than a little truth to the belief that a large share has held that orientation.) In short, for those who wish to find out what has made economics at the University of Chicago unique and important — and it is undoubtedly both, with the university having produced a widely disproportionate number of winners of the Nobel Prize, the John Bates Clark Medal, and the Francis A. Walker Medal (now defunct) — Van Overtveldt's book is the best single source currently available. **RF**

District Economic Overview

BY MATTHEW MARTIN

Economic activity in the Fifth District strengthened somewhat in the first quarter as growth in the District's service sector offset weakness in manufacturing. Housing markets remained generally soft across most of the District, though some markets reported slight improvements.

Economic activity in the Fifth District strengthened somewhat in the first quarter.

Labor Markets Robust

Reports on District labor market activity in the first quarter were generally positive, with ongoing job growth and declining unemployment. District payrolls expanded 1.4 percent during the first three months of 2007 — a solid performance that was only slightly below the 1.5 percent national pace over the same period. Employment gains were concentrated in the service sector, with the largest increases in education and health services as well as professional and business services.

Service-sector strength in the first quarter was also reflected in the results from the Richmond Fed's survey. First-quarter results showed that revenue growth expanded steadily at services firms. And although respondents — particularly retailers — indicated a softening in the pace of hiring during the quarter, business expectations were generally stronger for the six months ahead.

Solid job growth trimmed the District unemployment rate to 4.2 percent — the lowest rate posted since early 2001. Unemployment rates declined across all District jurisdictions, with the most substantial improvements occurring in West Virginia and South Carolina. Even with the improvement, South Carolina's unemployment rate led the District at 6.1 percent, while Virginia retained the lowest mark at just 2.9 percent — more than 1.5 percentage points below the national rate of 4.5 percent.

Manufacturing Sector Slows

Weakness in the District's manufacturing sector persisted as declining orders and rising inventories accompanied a pullback in production and a decrease in payrolls. District manufacturing activity continued to lose momentum after contracting modestly at the end of 2006. Product demand was notably weaker in the apparel and textiles, fabricated metals, furniture, and paper industries. The combined drop in shipments, orders, and employment pulled the Richmond Fed's composite index of manufacturing activity slightly into negative territory for the first time in nearly two years.

Weaker current conditions did not dampen respondent optimism regarding future demand, though, as the index of anticipated new orders for the second and third quarter increased by 10 percentage points over the previous period.

Economic Indicators

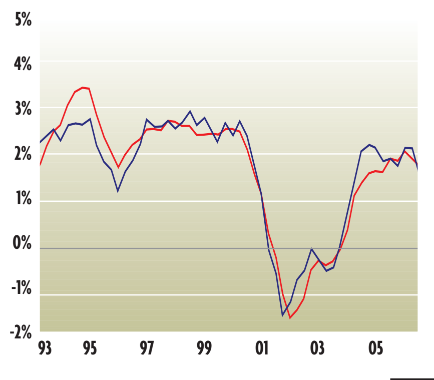
	1st Qtr. 2007	4th Qtr. 2006	Percent Change (Year Ago)
Nonfarm Employment (000)			
Fifth District	13,816	13,752	1.4
U.S.	137,447	136,951	1.5
Real Personal Income ($bil)			
Fifth District	934.9	923.5	3.1
U.S.	9,762.3	9,630.1	3.5
Building Permits (000)			
Fifth District	50.5	47.2	-21.0
U.S.	361.5	355.3	-26.6
Unemployment Rate (%)			
Fifth District	4.2%	4.4%	
U.S.	4.5%	4.5%	

Housing Markets Mixed

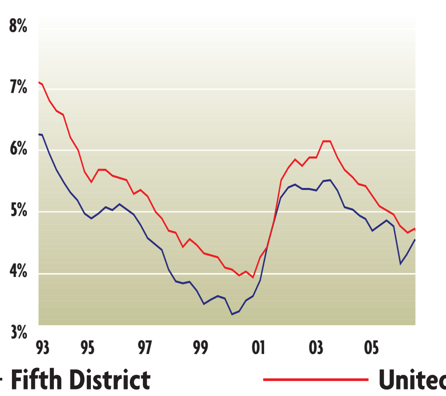
Residential real estate markets across the District were mixed as existing home sales increased, but new home construction declined. Existing home sales rose on a seasonally adjusted basis, though sales remained below year-ago levels in Maryland, Virginia, and South Carolina. Despite the modest gain in quarterly sales, home price appreciation generally eased across the District. While median home prices remained above year-ago levels, the pace of growth slowed — in some cases, to the low single digits. Low- to middle-priced homes remained the best sellers, though some reports indicated that houses in this category were difficult to find because of a shallow inventory.

The improvement in existing home sales did not extend to new home construction. Permitting activity was well below year-ago levels for all jurisdictions in the District. However, commercial activity generally held up well, with rising rents and evidence of new construction in many areas. Commercial construction activity helped to boost District construction payrolls, though Virginia saw construction employment decline 0.5 percent from a year earlier. By contrast, construction remained one of the faster-growing sectors in North Carolina, with employment up 4.7 percent from the same period last year. **RF**

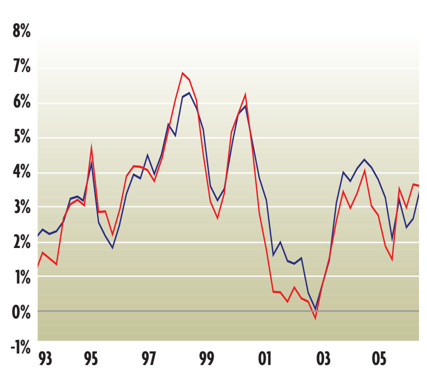
Nonfarm Employment
Change From Prior Year
First Quarter 1993 - Fourth Quarter 2006



Unemployment Rate
First Quarter 1993 - Fourth Quarter 2006

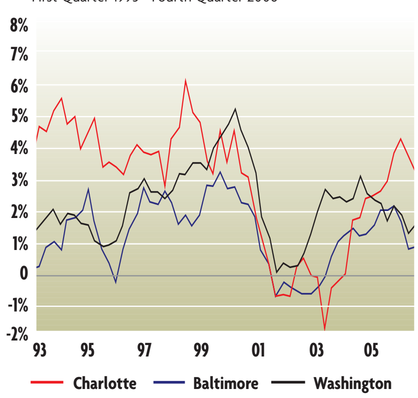


Real Personal Income
Change From Prior Year
First Quarter 1993 - Fourth Quarter 2006

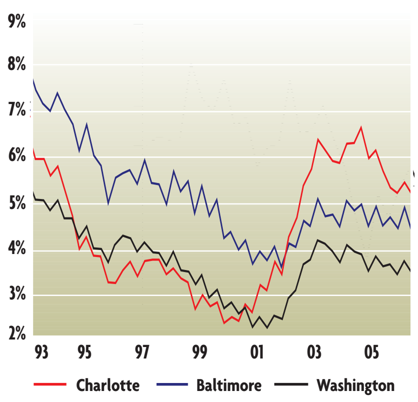


Fifth District — United States

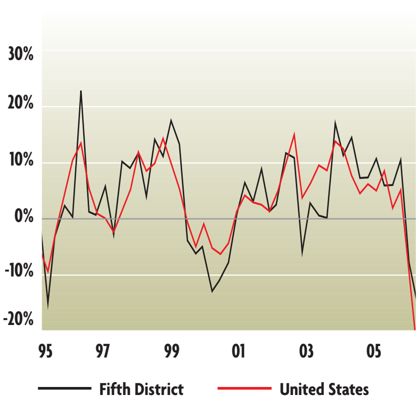
Nonfarm Employment Metropolitan Areas
Change From Prior Year
First Quarter 1993 - Fourth Quarter 2006



Unemployment Rate Metropolitan Areas
First Quarter 1993 - Fourth Quarter 2006

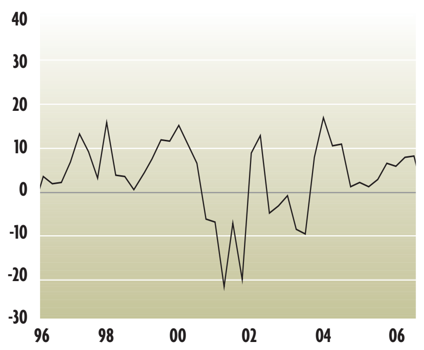


Building Permits
Change From Prior Year
First Quarter 1995 - Fourth Quarter 2006

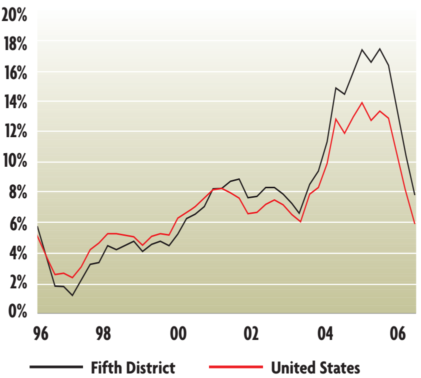


FRB—Richmond Services Revenues Index
First Quarter 1996 - Fourth Quarter 2006

FRB—Richmond Manufacturing Composite Index
First Quarter 1996 - Fourth Quarter 2006



House Prices
Change From Prior Year
First Quarter 1996 - Fourth Quarter 2006



Fifth District — United States

NOTES:
1) FRB-Richmond survey indexes are diffusion indexes representing the percentage of responding firms reporting increase minus the percentage reporting decrease.
The manufacturing composite index is a weighted average of the shipments, new orders, and employment indexes.
2) Metropolitan area data, building permits, and house prices are not seasonally adjusted (nsa); all other series are seasonally adjusted.

SOURCES:
Real Personal Income: Bureau of Economic Analysis/Haver Analytics.
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.
Building permits: U.S. Census Bureau, http://www.census.gov.
House prices: Office of Federal Housing Enterprise Oversight, http://www.ofheo.gov.

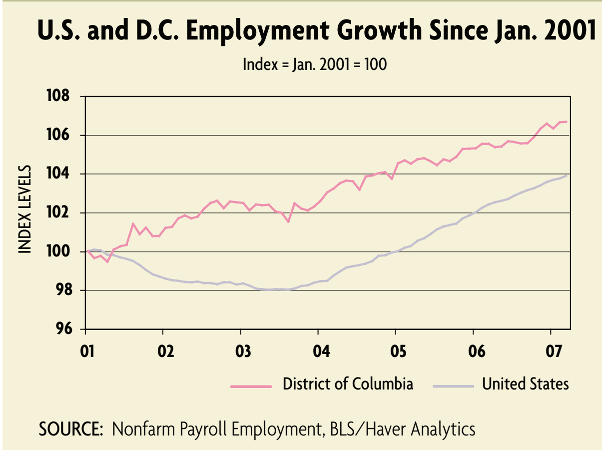
For more information, contact Matthew Martin at 704-358-2116 or e-mail Matthew.Martin @rich.frb.org.

State Economic Conditions

BY MATTHEW MARTIN

District of Columbia

The District of Columbia's economy performed well in the first quarter as overall growth stayed nearly on pace with that of the previous quarter. One particularly encouraging sign came from the household survey, which reported that the area's unemployment rate fell 0.3 percentage point to finish at 5.8 percent. And although that rate stood well above the national figure, the district's rate was at its lowest mark since the end of 2000. The drop in the unemployment rate was especially encouraging because it occurred amidst strong growth in the area's labor force, which expanded at a 3.8 percent annual rate during the first quarter of 2007 – its largest increase in two years.



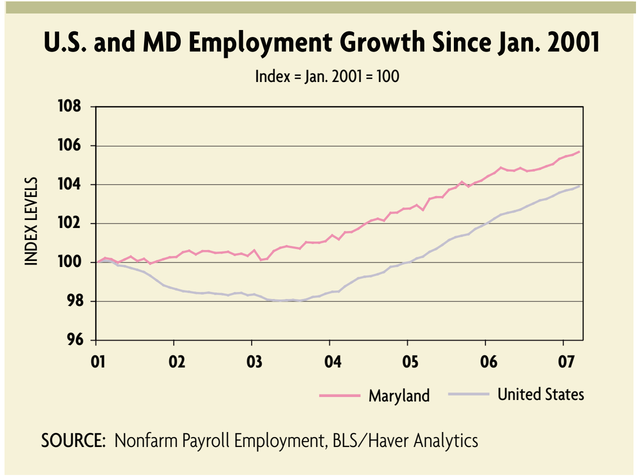
Other measures of labor market activity were mixed. Payroll employment growth in the District of Columbia eased in the first quarter compared to the previous period, though the moderation followed an especially large gain during the final quarter of 2006. Payrolls expanded at a 1.1 percent annual rate in the first quarter on the strength of a 4.7 percent increase in professional and business services employment. However, job growth was constrained by quarterly declines in both the government and financial activities sectors. Employment in those sectors was also lower than year-earlier levels, constraining overall job growth to just 1.0 percent.

Turning to real estate, stronger sales of existing homes during the first three months of 2007 helped to inject some life into the District of Columbia's housing market. Sales activity rebounded in the first quarter, following an especially weak final quarter of 2006 when sales fell to their lowest level in a decade. Home sales reached an annual rate of 11,800 units sold during the quarter, the highest mark since the fall of 2005. Not all reports on the area's housing market were positive, however. Building permit levels declined 37.2 percent compared to a year earlier — 2006 was a first-quarter record for permits — but remained well above levels recorded two years earlier. The decline in new home construction also accompanied a further deceleration in home price appreciation. Home price growth in the area slowed during the quarter to a 2.0 percent annual rate compared to 9.0 percent in the previous period, marking the slowest pace for home price growth since 1998.

Maryland

Maryland's economy retained its momentum of late 2006, posting another solid performance during the first quarter. Payroll employment increased at a 1.7 percent annual rate in the quarter — moderately faster than in the last quarter of 2006. A 7.7 percent jump in leisure and hospitality employment combined with a 5.9 percent increase in professional and business services payrolls accounted for a bulk of the growth. Construction employment also held up, increasing 5.2 percent. Employment gains in these sectors were enough to overcome the loss of jobs in several other sectors. In addition to the persistent loss of manufacturing jobs, the state shed jobs in the information and government sectors. Compared to a year earlier, however, government payrolls increased slightly, while manufacturing and information services firms trimmed workers.

First-quarter data from the household sector also suggested an overall improvement in Maryland's labor market. The unemployment rate fell 0.2 percentage point to 3.7 percent in the first quarter — the state's lowest mark in a year. However, the labor force contracted at a 0.6 percent annual rate in the first quarter, marking the state's first quarterly decline since early 2004. But the dip wasn't persistent as labor force growth in the state remained in



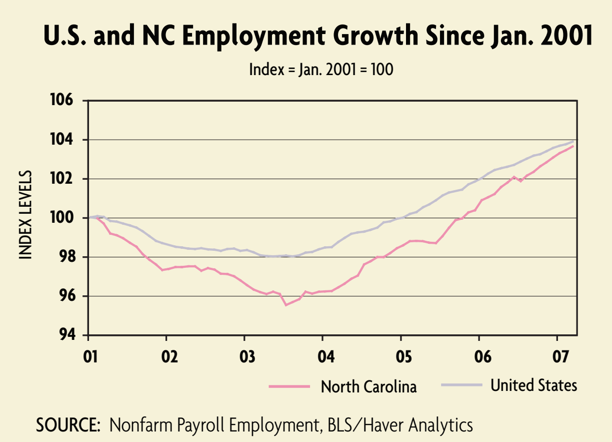
positive territory compared to a year earlier.

On the real estate front, the housing market remained a weak spot in the state's economy, though softer housing activity has been less pronounced than in other District jurisdictions. Existing home sales actually rose during the first quarter, but were 10.0 percent below year-earlier levels. Additionally, new home construction declined further during early 2007, with permits down 13.3 percent compared to last year. In comparison to the rest of the District, however, Maryland's decline in permits has been less sharp. The recent softness in sales and construction activity has contributed to slower home price appreciation. Prices increased at a mild 1.9 percent annual rate in the first quarter, though they were up 6.4 percent since the first quarter of 2006.

North Carolina

North Carolina's economy remained strong in the first quarter of 2007, though the pace of growth eased somewhat. Payroll employment growth slowed a bit, increasing at a 2.4 percent annual rate in the first quarter, compared to a 2.9 percent rate in the previous period. Nonetheless, job growth in the first quarter was enough to trim the state's unemployment rate to its lowest level since the end of 2000. The unemployment rate fell 0.4 percentage point to finish at 4.5 percent. North Carolina's mark remains higher than the overall unemployment rate for the District, however, due in part to large increases in the state's labor force in recent years.

U.S. and NC Employment Growth Since Jan. 2001



SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

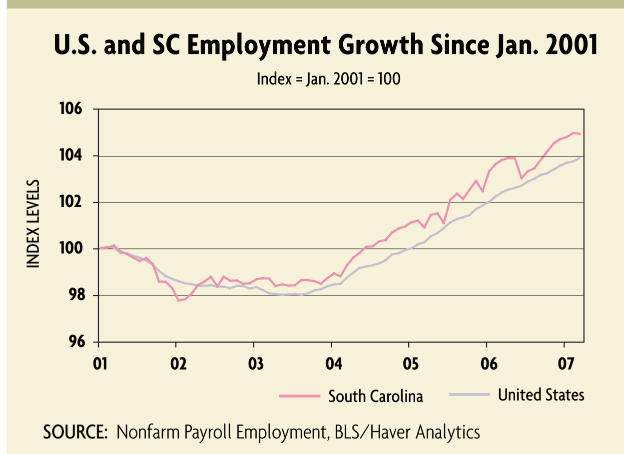
Slightly slower job growth in the first quarter was due to a pullback in the pace of service-sector job growth. Employment growth in financial services slowed considerably, inching up just 0.2 percent on an annualized basis on the heels of a 6.3 percent increase in the final quarter of 2006. Job gains in professional and business services were solid at a 4.0 percent annual rate, though a bit softer than the 4.4 percent rate posted in the previous quarter. An acceleration of job losses in manufacturing also contributed to the state's overall slower job growth figures.

Assessments of North Carolina's housing market during the first quarter of 2007 were mixed. The most substantial change was on the construction side. First-quarter building permits were 12.7 percent lower than year-earlier levels, although 2006 was a record-setting year for permit issuance. Existing home sales were more buoyant, however, rising 0.7 percent in the first quarter compared to the previous year. Measures of both new home construction and existing home sales compared favorably to other District jurisdictions, as did measures of home appreciation. Home prices rose 6.9 percent on an annual basis in the first quarter and were up 8.0 percent since the first quarter of 2006 — both District bests.

South Carolina

The South Carolina economy improved in the first quarter of 2007 as steady job growth added to a sizable reduction in the state's unemployment rate. The unemployment rate fell 0.5 percentage point in the first quarter to 6.1 percent — the lowest since the third quarter of 2002. Strong service-sector employment growth helped fuel the overall improvement in job numbers. Job growth over the past year was strongest in the state's education and health services industry. Employment in the sector increased 6.6 percent compared to a year earlier. Financial and construction services were also among the fastest-growing segments of

U.S. and SC Employment Growth Since Jan. 2001



SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

the economy during this period, with job growth rates of 4.3 percent and 3.0 percent, respectively. Manufacturing jobs continued to be the only drag on the state's overall job growth with factory employment falling 3.7 percent compared to a year earlier.

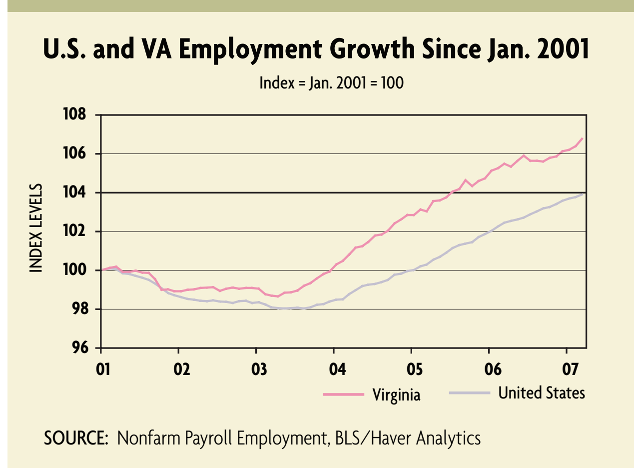
Despite the strong job numbers, weakness in South Carolina's housing markets persisted during the first three months of 2007. Permit issuance declined sharply in the first quarter, with declines concentrated in coastal markets, particularly Charleston and Hilton Head. New permits declined 44.3 percent compared to a year earlier in Charleston during the quarter, which accounted for a substantial share of the state's overall decline. Inland markets fared somewhat better, with permit levels off 18.6 percent in Columbia and up 6.6 percent in Greenville. The decline in new home building was partially in response to the growing inventory of homes and slower sales activity experienced across the state. The slowdown in overall housing activity also led some home builders to trim payrolls in the first quarter. Increased commercial construction over the past year helped mask the losses, however, and prevented an overall decline in construction employment in the first quarter.

Virginia

Virginia's economy continued to expand during the first quarter of 2007 and it remained among the healthiest economies in both the District and the nation. Results from the household employment survey during the quarter provided a clear signal of the state's economic strength. The unemployment rate fell 0.1 percentage point to 2.9 percent, the lowest mark in the District by nearly a full percentage point and more than 1.5 percentage points below the national rate.

Payroll job growth in Virginia was on par with the rest of the District during the first quarter. Service-sector growth remained strong, led by a 4.3 percent increase in professional and business services employment. The professional and business services sector has been the fastest-growing in the state over the past year, followed by education and health services, leisure and hospitality, and financial services. As with the rest of the District, state manufacturers continued to trim payrolls as the sector remained the state's weakest, in terms of employment performance.

Though its overall economy remained strong, Virginia's housing sector continued to be a weak spot during the first three months of 2007. First-quarter data indicated that the housing market cooling in the state continued to be generally more pronounced than in the rest of the District. New building permits for residential construction declined 30.1 percent compared to the previous year, while existing home sales were off 5.7 percent. Weakness in building and sales activity during the period also contributed to a reduction in the state's construction payrolls. Construction employment began to decline in the second half of last year as housing market activity softened, but the decline in construction employment intensified in the first quarter of 2007. Construction payrolls were down 1.3 percent compared to the first quarter of last year, making the state the only District jurisdiction to experience a year-over-year decline in construction employment. On a brighter note, the state's overall mortgage delinquency rate edged lower during the fourth quarter and — at 3.1 percent — remained below readings in other District jurisdictions.



SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

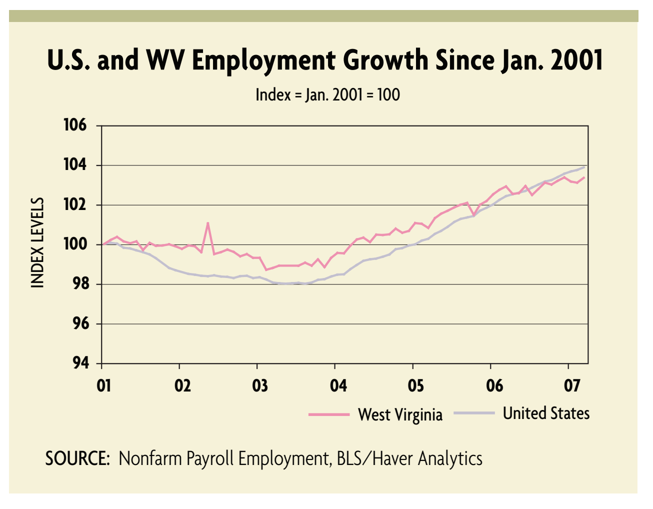
West Virginia

Economic growth in West Virginia slowed in the first quarter as a sluggish labor market constrained income growth and weakness in residential real estate persisted.

Employment in the state treader water in the first quarter, with payroll levels unchanged from the fourth quarter. Several sectors of the state's economy weighed on job growth. Manufacturing payrolls in West Virginia continued to contract at a faster pace than in other District jurisdictions with the exception of South Carolina. The state also suffered its first quarterly decline in mining employment since the end of 2003. There were bright spots, however. The largest employment gain was in trade, transportation and utilities employment, which increased at a 4.0 percent annual rate. This sector posted the strongest employment gains over the past year as well, followed by increases in construction and leisure and hospitality payrolls.

Nonetheless, West Virginia experienced the weakest employment growth in the District over the past 12 months, with total employment increasing by less than 1.0 percent.

West Virginia's residential real estate markets also continued to be a drag on the state's overall economy in the first quarter of 2007. Home prices fell 0.8 percent during the first three months of the year, marking the first quarterly decline in home values in the state since the fourth quarter of 1999. In addition, housing construction activity continued to slump as first-quarter permit levels dropped off 40.1 percent compared to the same period a year earlier. Despite the lackluster price and construction numbers, West Virginia experienced a 1.4 percent uptick in home sales – the state's first year-over-year increase in sales activity in more than a year. **RF**

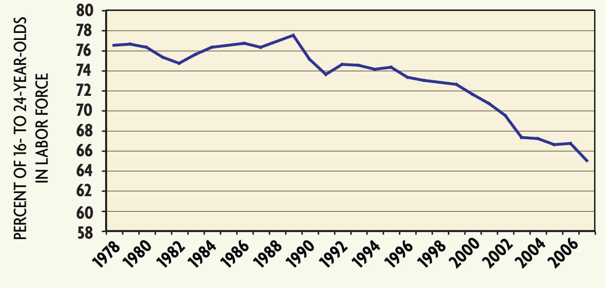


SOURCE: Nonfarm Payroll Employment, BLS/Haver Analytics

Behind the Numbers: Youth Employment

The percentage of young people who seek summer jobs is on the decline. According to recent data from the Bureau of Labor Statistics (BLS), the labor force participation rate for people aged 16 to 24 was 65 percent in July 2007, well down from its 1989 peak of 77.5 percent.

But there may be no need to fret the younger generation's work ethic. As the BLS notes, the decrease in labor force participation for the youth has coincided with growing enrollment in summer school. Since future earnings are highly tied to education, young people may be making a wise choice in putting off employment to attend school.



SOURCE: Bureau of Labor Statistics

As it does every year, the number of employed youths increased between April and July of this year. But the 2007 increase of 2.3 million was less than last year's seasonal increase of 2.5 million. Unemployment among younger workers grew by 548,000, a slightly smaller gain than in 2006.

The youth labor force reached 24.3 million in July, with 21.7 million of those employed. Young men represent a greater share of the labor force, with a 67.9 percent participation rate compared with young women's 62.1 percent. Labor force participation for whites aged 16 to 24 was 68 percent; for blacks, 54.1 percent; and Hispanic, 59.5 percent. Unemployment was lowest among Asians (7.7 percent) and highest for blacks (20.5 percent).

About one in four employed youths works in the leisure and hospitality industry (which includes restaurants). Almost one in five works in retail. Come fall, almost 2 million youths are expected to give up employment, presumably returning to the classroom.

A more detailed look at the composition of the youth work force was provided in a landmark 2001 BLS report. Data from a national longitudinal survey of 14- and 15-year-old taken in 1997 showed that most youths who chose to work did so during both the school year and the summer. Of the 31.9 percent of surveyed youths with jobs, only 7 percent worked exclusively during the summer.

Early teens from relatively wealthy families were more likely to hold jobs in the first place. According to the survey, 38.9 percent of 14- and 15-year old from families with more than $70,000 in annual income had jobs during some part of the year; it was 24.1 percent of youths from families earning less than $25,000 a year. — Doug Campbell

State Data, Q1:07

	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000)	693.8	2,605.7	4,079.6	1,922.9	3,755.5	758.6
Q/Q Percent Change	0.3	0.4	0.6	0.4	0.5	0.0
Y/Y Percent Change	1.0	0.9	2.4	1.3	1.1	0.5
Manufacturing Employment (000)	1.6	133.9	546.0	244.2	285.3	59.4
Q/Q Percent Change	-4.0	-1.2	-1.1	-1.2	-0.1	-1.4
Y/Y Percent Change	-11.1	-1.9	-1.0	-3.7	-1.7	-3.2
Professional/Business Services Employment (000)	155.6	392.2	478.6	214.0	631.7	59.3
Q/Q Percent Change	0.0	-1.4	-0.9	-2.3	-0.5	-2.0
Y/Y Percent Change	4.4	1.8	4.2	0.3	2.6	-0.4
Government Employment (000)	231.9	470.6	678.4	331.6	674.9	144.6
Q/Q Percent Change	-0.3	-0.4	0.5	0.4	0.2	-0.3
Y/Y Percent Change	-0.7	0.4	0.9	0.1	0.6	0.2
Civilian Labor Force (000)	320.8	3,026.2	4,518.2	2,160.0	4,051.4	812.6
Q/Q Percent Change	0.9	-0.2	0.2	0.7	0.6	0.1
Y/Y Percent Change	1.8	1.4	2.4	2.3	2.2	1.6
Unemployment Rate (%)	5.8	3.7	4.5	6.1	2.9	4.2
Q4:06	6.1	3.9	4.9	6.6	3.0	5.1
Q1:06	5.9	3.7	4.7	6.5	2.9	4.6
Personal Income ($bil)	28,960.2	222,413.7	257,281.0	114,549.1	266,383.7	45,327.9
Q/Q Percent Change	1.3	1.2	1.3	1.3	1.2	0.9
Y/Y Percent Change	2.8	3.3	3.8	3.4	2.2	3.1
Building Permits	834	5,456	23,149	10,510	9,646	881
Q/Q Percent Change	149.7	-8.6	7.4	12.5	6.0	-0.7
Y/Y Percent Change	-37.2	-13.3	-12.7	-27.4	-30.1	-40.1
House Price Index (1980=100)	662.0	540.1	337.2	322.6	474.2	233.5
Q/Q Percent Change	0.5	0.5	1.7	1.3	0.7	-0.2
Y/Y Percent Change	5.9	6.4	8.0	7.6	5.4	3.9
Sales of Existing Housing Units (000)	11.8	115.5	244.1	116.8	149.0	36.9
Q/Q Percent Change	40.5	13.7	8.2	14.1	18.6	26.4
Y/Y Percent Change	9.3	-10.0	0.7	-2.7	-5.7	1.4

NOTES:
Nonfarm Payroll Employment, thousands of jobs, seasonally adjusted (SAC) except in MS; Bureau of Labor Statistics (BLS)/Haver Analytics, Manufacturing Employment, thousands of jobs, SAC in all but DC and SC; BLS/Haver Analytics, Professional/Business Services Employment, thousands of jobs, SAC in all but SC; BLS/Haver Analytics, Government Employment, thousands of jobs, SAC; BLS/Haver Analytics, Civilian Labor Force, thousands of persons, SAC; BLS/Haver Analytics, Unemployment Rate, percent, SAC except in MS; BLS/Haver Analytics, Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics, Sales of Existing Housing Units, thousands of units, SAC; National Association of Realtors®

Metropolitan Area Data, Q1:07

	Washington, DC MS	Baltimore, MD MS	Charlotte, NC MS
Nonfarm Employment (000)	2,396.1	1,288.8	832.2
Q/Q Percent Change	-0.8	-2.1	-0.5
Y/Y Percent Change	1.7	0.5	3.2
Unemployment Rate (%)	3.2	4.2	4.6
Q4:06	2.9	3.8	4.7
Q1:06	3.1	4.1	4.8
Building Permits	6,391	1,742	5,635
Q/Q Percent Change	40.4	-4.5	-6.1
Y/Y Percent Change	-26.5	-26.7	-8.3

	Raleigh, NC MS	Charleston, SC MS	Columbia, SC MS
Nonfarm Employment (000)	488.7	291.5	363.7
Q/Q Percent Change	-1.1	0.6	-0.7
Y/Y Percent Change	3.6	4.1	1.9
Unemployment Rate (%)	3.6	4.9	5.5
Q4:06	3.6	5.1	5.5
Q1:06	3.8	5.2	5.5
Building Permits	4,064	1,424	1,674
Q/Q Percent Change	19.6	-26.4	22.5
Y/Y Percent Change	-15.1	-44.5	-18.6

	Norfolk, VA MS	Richmond, VA MS	Charleston, WV MS
Nonfarm Employment (000)	762.2	628.9	148.6
Q/Q Percent Change	-1.2	-0.9	-1.3
Y/Y Percent Change	1.3	2.2	1.0
Unemployment Rate (%)	3.3	3.2	4.5
Q4:06	3.1	2.9	4.2
Q1:06	3.5	3.3	4.9
Building Permits	2,113	1,809	75
Q/Q Percent Change	5.8	21.7	44.2
Y/Y Percent Change	-8.5	-22.0	-10.7

For more information, contact Matthew Martin at 704-358-2116 or e-mail Matthew.Martin@rich.frb.org.

OPINION

Why I Want To Be An Economist

BY ANDREA WADDLE

My interest in economics was born from my family's involvement in international development projects. My dad is an electrical engineer. His firm builds energy projects in third-world countries, providing electricity to rural areas. When I was 8 years old we moved to La Paz, Bolivia. Part of the reason why my parents wanted to take the family overseas was so my brothers and I would understand what it means to be truly poor. Poverty is intense in Bolivia. Homelessness is pervasive; children are living on each street corner. Poor in Bolivia means you're probably not going to eat today, and you'll be lucky if you eat tomorrow. We came back to Oak Ridge, Tenn., when I was 12. I returned to Bolivia about every other year, including spending a month working in an orphanage in Caranavi.

Because we grew up overseas, my brothers and I all have an interest in effecting some sort of change. My dad goes out and he really changes people's lives. Because of his work, households will enjoy electric lighting; shops will have the opportunity to buy and use electric appliances; workshops will be able to use power tools. Because of the disparity I saw firsthand between the lifestyles led in the developed world versus those led in the developing world, I wanted to have an effect on an international scale.

My first economics course at the University of South Carolina was in microeconomics, and it was very tough. Dr. Blackburn, my teacher, is known for being "a weed-out professor." But he held my interest because he kept pushing this idea that all we're doing with economics is trying to understand the world. I love math, but I could never be a pure mathematician because it lacks a human element. Economics uses mathematical tools that I've always liked to explain things about the way people interact and make decisions. Microeconomics was the first class where I really felt challenged in college.

What I came to find here at the Richmond Fed Research Department is a really great intellectual community. People here are making strides toward answering questions that are important. I've been fortunate to work with some people who see it as part of their job to teach me. I've benefited immensely from my work with economist Kartik Athreya. I work hard for him, but I'm repaid for that work because he takes an interest in teaching me to understand the models that we work with, which contributes to my general knowledge in the field. What being here has taught me is that I can be interested in almost any subfield of economics. I'll probably end up doing something in the growth and development literature because that's where my passion is. But now I'm prepared to look at almost any question that can be addressed by an economist because I can grasp more of the concepts.

That said, there's a lot in economic theory that I don't understand right now. General equilibrium theory, game theory stuff – I don't know much about any of it. But to seriously think through any economic question, I need to. Why is it that the government of Bolivia has decided to expropriate everything and send the nation into chaos? To understand that, as well as the effects of it, I need to know models of political economy, and to understand political economy I need to have a grasp on game theory. The politicians are making decisions knowing that in some period in the future they are going to have to interact with countries like the United States. They should know they are hurting their citizenry in some way, so how do they benefit from this decision? I can't make headway into that question until I get my micro-theory shored up.

> Economics is mostly a system of approaching problems, a way to think.

Economics is mostly a system of approaching problems, a way to think. There is a danger in thinking like an economist, always putting everything in a little box, a model. But to a certain extent, to fully explore questions you need a systematic approach. What I'm excited about in entering a Ph.D. program is getting to figure out how theory shapes our understanding of how things work. I'd like to understand why certain theories seem to pan out while others don't, and right now I don't have all the tools to make that possible. That's what I'm excited about.

A part of me worries that I'll never have the same job satisfaction that I would have if I became an engineer. In economic research, it's a very rare person who gets to make a huge discovery. I know I'm not going to be the next person who comes up with the reason why countries like Bolivia completely stagnate economically. I tell myself not to get discouraged with just adding a piece to that puzzle. Solving the whole puzzle is very hard. But making a contribution, that's also important. **RF**

Andrea Waddle worked the past two years as a research associate at the Federal Reserve Bank of Richmond. This fall she begins graduate studies in economics at the University of Pennsylvania.

NextIssue

Downtowns

There was a time when downtowns were the center of economic life in nearly every American city. Those days are gone, but some downtowns are making a comeback. A visit to the bustling, rejuvenated downtown in Greenville, S.C., reveals how they are reinventing themselves. The most successful have transformed into niche markets, catering to young professionals and empty-nesters in search of walkable neighborhoods, good food, and boutique shops.

Forecasting

Each year, awards are handed out to the nation's top economic forecasters. But is there such a thing as a "star" forecaster, somebody who consistently beats the crowd? If so, such stars must be in possession of either superior instincts or superior forecasting models. Perhaps it's a bit of both.

Subprime Market

A close look at borrowers in the subprime mortgage market suggests that some, with a little counseling, self-education, and patience, could have sought home financing on better overall terms. The experience of one nonprofit housing organization in Raleigh, N.C., is particularly relevant.

The Hidden Strength of Fragile Banks

Banks finance loans with deposits that can be withdrawn on demand. Economist Douglas Diamond, a visiting scholar with the Richmond Fed, and his colleague Raghuram Rajan at the University of Chicago Graduate School of Business, think that while this inherently fragile capital structure makes banks prone to runs, it also keeps bank managers honest and thus enhances liquidity. Their theory has implications for the role of deposit insurance and capital requirements.

Interview

We talk with Susan Athey of Harvard University, the most recent winner of the John Bates Clark Medal, awarded biennially to the American economist under the age of 40 judged to have made the most significant contribution to economic thought and knowledge. Athey has long ties to the Fifth District: She grew up in Maryland and was an undergraduate at Duke University.

Economic History

Some 28 million people moved North during the Great Migration, altering the nation's racial and ethnic composition. The Great Migration changed job markets, politics, society, and culture. For blacks, in particular, the exodus urbanized a largely agricultural and rural population.

Federal Reserve

Before the Federal Reserve, bankers in the United States struggled with an uneven regulatory environment, multiple currencies, and the ever-looming danger of runs. Still, the financial system worked relatively well.

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Inflation, Unemployment, and the Phillips Curve

What is the nature of the relationship between economic growth and inflation? This is a question that economists have pondered since the days of Adam Smith. For the past 50 years, many economists have analyzed the issue by turning to the Phillips curve, named after Australian economist A. W. Phillips. This tool may not provide the definitive answer that many once thought, however. According to two Richmond Fed senior officials, there is another factor at play in this relationship: public expectations.

In the Federal Reserve Bank of Richmond's *2006 Annual Report* feature article, "Inflation and Unemployment: A Layperson's Guide to the Phillips Curve," the Bank's President and the Senior Vice President and Director of Research trace the history of thought about the relationship between growth and inflation and look at current economic conditions using the Phillips curve. They contend that public expectations about the conduct of monetary policy — something largely not considered in the initial versions of Phillips curve analysis — play a dominant role in how inflation and unemployment interact. Maintaining economic stability, then, hinges largely on people's confidence in future policy actions to keep inflation low and predictable even when the economy experiences substantial changes in conditions.

The annual report also includes messages from the President and First Vice President, a report on the Fifth District economy, and an overview of the Richmond Fed's 2006 financial activity.

The *2006 Annual Report* is available on the Bank's Web site at www.richmondfed.org/publications/economic_research. Print copies are available free of charge and can be ordered online or by contacting the Bank's Public Affairs Department at 804-697-8109.

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