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REGION FOCUS

SUMMER 2003

THE FEDERAL RESERVE BANK OF RICHMOND

Dollars and Defense

Measuring the Economic
Effects of the Military



REGION FOCUS

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Dollars and Defense: A Closer Look at How Military Spending Affects Fifth District Communities in Times of War and Peace

The military's effect on the economy is highly visible during times of war. But its peacetime effects shouldn't be ignored either, especially in the Fifth District. There are many large military bases throughout the region, each of which plays an important role in the economic life of its community.

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Liquid Assets: Who should sell hard liquor in the Fifth District – state-run monopolies or private companies?

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Our mission is to provide authoritative information and analysis about the Fifth Federal Reserve District economy and the Federal Reserve System. The Fifth District consists of the District of Columbia, Maryland, North Carolina, South Carolina, Virginia, and most of West Virginia. The material appearing in *Region Focus* is collected and developed by the Research Department of the Federal Reserve Bank of Richmond.

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Guns and Butter



An increase in the production of defense-related goods and services must necessarily draw resources away from the production of other goods — more guns mean less butter at the national level.

Editor's Note: We introduce "Research Spotlight" on page 11 of this issue. This department discusses an important scholarly economics article in a nontechnical way. Let us know what you think about the department and Region Focus by sending an e-mail to: rich.regionfocus@rich.frb.org.

Economics is all about trade-offs. Most textbooks introduce the student to the idea of trade-offs with a diagram called a "Production Possibilities Frontier." This graphic device considers the hypothetical case of an economy in which only two goods are produced and shows the combinations of the two goods that are technically feasible, given the economy's resources and know-how. It demonstrates the fact that you can't get more of one good without giving up some of the other. At least since Paul Samuelson first published his famous, standard-setting textbook in 1948, it has been popular to label the two goods in question "Guns" and "Butter." This dichotomy, which probably has its origins in political discussions about the costs of military build-ups prior to the First World War, captures the very real trade-off societies typically face in the allocation of resources between national defense and private consumption goods. This same basic trade-off applies to all goods and services produced by the government.

While choices about military spending are made through the political process at the national level, such decisions can have significant effects on local economies. This issue's cover story details the military's economic impact on Fifth District communities, as well as the economic drain those communities feel when large numbers of troops are deployed overseas. The boost that a military presence gives

to a local economy may create the impression that a simultaneous increase in both guns and butter is possible, contrary to the trade-off posed in textbooks. This impression would be mistaken and would result from a failure to distinguish local from aggregate effects. More military spending—more guns at the national level—can certainly mean a stronger local economy—more butter—for regions with relatively high concentrations of military facilities. At the aggregate level, however, the economy has only a limited amount of resources available for the production of all goods. An increase in the production of defense-related goods and services must necessarily draw resources away from the production of other goods—more guns mean less butter at the national level.

A production possibilities frontier represents the set of choices available to an economy. While resources and technology determine this set, the actual choice to be made depends on the relative value that society as a whole places on alternative combinations of guns and butter. This sort of decision problem is easy to describe in terms of economic theory, but, in practice, the social value of increased spending on defense can be hard to pin down in precise quantitative terms. Most goods are allocated by markets, and individuals buy the amount they want, based on their private valuations. There is typically no need for *society* to make a conscious, collective determination of value. But national

defense comes as close as any good or service to what economists call a "pure public good." The benefits of a dollar spent on defense are shared by all citizens. Individuals cannot make their own independent decisions about how much defense to buy.

The public-good nature of defense necessarily makes military spending a political decision. As such, and especially in times of war or international crisis, we sometimes overlook or set aside the economic aspects of this decision. And while the cost (in butter) of more guns cannot be avoided, it can be delayed through government borrowing. Since borrowed funds will need to be repaid in the future, the choice is actually between taxation now and taxation in the future. Even beyond the issue of financing defense expenditures, the issue of taxation and government deficits has been much in the news recently, as discussed in our Legislative Update feature. As that piece makes clear, economists continue to debate the effects of deficit spending on economic performance. One thing, however, is certain. Public expenditures must be paid for, regardless of one's beliefs about the effects of government deficits or the efficacy of government spending. Sooner or later, more guns (or interstate highways, or cancer research, for that matter) mean less butter.

Al Broadus

AL BROADUS
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND

Ready to Lend

The Discount Window's Evolving Role as a Liquidity Lifeline for Depository Institutions

BY CHARLES GERENA



In the early days of the Federal Reserve, bankers visited the discount window when they needed to borrow reserves unexpectedly.

In the past, people visited their friendly neighborhood banker to borrow money for a new house. Now, consumers can get mortgages online.

In the early days of the Federal Reserve System, bankers visited the friendly neighborhood discount window to borrow reserves when there was a run on deposits or an unexpected rise in loan volume. They brought their collateral to a teller window at a Federal Reserve Bank.

The window doesn't operate from the lobby of the Richmond Fed's downtown office anymore. It occupies a corner of the 18th floor, where the men and women of the Loans Department work the phones and computers to help depository institutions establish lending agreements and pledge collateral.

The department's most significant activity isn't processing loans, though. "We make a handful of loans a month on average, but we have to be prepared to lend to hundreds of institutions," says Senior Manager Gregory Robinson. "We have to constantly monitor the collateral that would secure those loans if institutions come to us."

Borrowers also don't have to physically take their collateral to the Fed. They can pledge assets, such as a portfolio of consumer or commercial loans, and maintain possession of them.

Amid these and other changes, the mission of the discount window remains — to relieve liquidity strains on individual institutions and the banking system as a whole. Over the years, the Fed has tried to balance the window's role in keeping financial markets stable against the need to curtail lending that may unintentionally support financially troubled institutions.

The latest attempt to address this issue was in January, when the Fed reorganized the window's operations. To understand the significance of these changes, however, they must be viewed against the backdrop of the discount window's continuing evolution.

When the Federal Reserve System was created in 1913, the discount window was its primary instrument of monetary policy. By affecting the amount of reserves held by banks, the Fed could influence the amount of money and credit available in the U.S. economy.

The window provides reserves through two vehicles — discounts and advances. With the former, a bank provides the Fed with an asset like a short-term business loan. In return, it receives credit equal to the asset's value at maturity minus a "discount" based on the discount rate, which is the interest charged on the loan. When the asset matures, the Fed returns it to the bank and receives a cash payment equal to the maturity value.

An advance is much simpler than a discount. A bank pays interest at the discount rate to receive a loan from the Fed against acceptable collateral. Currently, the window supplies all of its reserves in the form of advances.

Each of the Federal Reserve's 12 banks could change the discount rate in response to economic conditions in its district. When the supply of money and credit tightened, it lowered the rate and made it easier for banks to increase their reserves. When there was too much money, it made it harder for banks to boost reserves. (Today, discount rates across the Federal Reserve System are normally in sync.)

The discount window remained the

Federal Reserve's dominant monetary policy tool until the effectiveness of Open Market operations emerged in the 1920s. Through this tool, the Fed buys government securities to pump money into the financial markets, or sells securities to absorb money. Open Market operations are effective only when financial markets are broad and deep, and America's markets had reached that point.

George Kaufman, director of the Center for Financial and Policy Studies at Loyola University, Chicago, points out several advantages of Open Market operations. "It reduces the political pressures on [the Fed] to assist all entities in financial distress, in particular, financially weak but politically strong entities," he wrote in a November 1999 paper. "The private market is less likely to direct additional funds ... to such entities."

Also, "efficient markets price funds provided through Open Market operations at the current market rate for the particular risks involved. In contrast, funds provided through the discount window are priced administratively and, if priced incorrectly, may both misallocate resources and reduce the effectiveness of the assistance."

As Open Market operations took center stage at the Fed, the discount window stepped into the sidelines in subsequent decades. According to economist Allan Meltzer at Carnegie Mellon University, the Fed discouraged banks from window borrowing. "They took the position that borrowing was a privilege, not a right," explains Meltzer, who recently wrote a historical account of the Federal Reserve from 1913 to 1951. "In the early days, they would do it by restricting the kind of collateral that they would take. Later ... they would talk to banks about [the potential problems of] continuous borrowing."

Staff at the discount window explained that credit was intended only to meet unexpected shortfalls in reserves on a limited basis. Also, Federal Reserve regulations required borrowers to exhaust all other sources of credit before coming to the window. A depos-

itory institution wasn't supposed to borrow from the window to boost its normal lending capacity, or to exploit the spread between the discount rate and the federal funds rate, which is the interest that institutions charge to borrow reserves from each other.

At the same time, alternative sources of credit expanded like the federal funds market, which Meltzer believes is more efficient than window borrowing because reserves flow to where they are most needed. Bankers also learned to manage their reserves better.

Window volume spiked during the 1980s when reserves flowed to troubled savings and loans, but it has generally remained low as the discount window began to be regarded as "a lender of last resort." Institutions have obtained credit from other sources, including the federal funds market, the nationwide Federal Home Loan Bank System, and larger institutions with which they have a correspondent relationship.

According to the team at the Richmond Fed's discount window, large complex banking organizations in the Fifth District don't frequent the window very often. "But when they come, they usually have a big need," notes Robinson. "Something has happened in the financial markets, and they can't get the funds that they need."

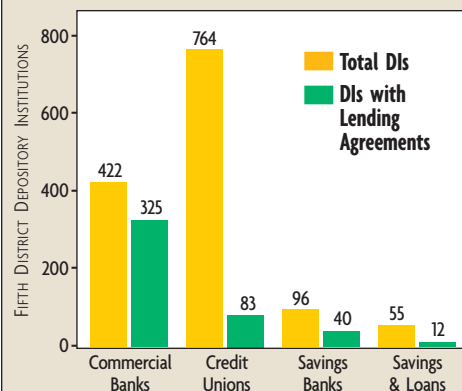
A prominent example was Sept. 12, 2001, the day after terrorists struck the World Trade Center and the Pentagon. Loan volume reached \$45 billion that day. But there have been other instances when large banks have employed the window. For example, The Bank of New York got a \$23 billion loan in 1985 when a computer glitch interrupted its transaction processing.

Regional and community banks usually borrow small amounts of reserves periodically for less dramatic reasons, says Rebecca Snider, assistant vice president of the Loans Department. It can be late in the afternoon and a bank official realizes that reserves are running short due to human error or an operational problem.

But, smaller institutions visit the

Who Knocks at the Window?

About 460 of the Fifth District's 1,300 depository institutions have lending agreements with the discount window. The other 11 Federal Reserve Districts combined have about the same ratio of institutions ready to use the window—5,500 out of 16,700.



SOURCE: Federal Reserve Bank of Richmond

discount window more often than larger ones because they have fewer funding sources with earlier cutoff times for filing requests, notes Nita Tinsley, one of the department's senior analysts. "We are here 'til the cows come home, or a half hour afterwards." (The window stays open 30 minutes after the close of Fedwire, which transfers funds between depository institutions until 6:30 p.m.)

Bad weather also accounts for some window borrowing by smaller institutions. Tinsley says that even when bank employees can't make it to work, transactions still post to the institution's reserve account. "Bankers don't know what their balance is, so they'll call to get the balance and borrow to cover whatever is needed."

Seasonal changes don't drive smaller borrowers to the Fifth District's discount window as they do elsewhere. Normally, seasonal credit flows from the window into agricultural communities because farmers withdraw funds and request loans at the beginning of every growing season to plant crops. This can drain a bank's deposits and increase loan volume, explains Robinson. But agriculture is more prominent in other regions like the Midwest.

Whether it's a snowstorm or a

blackout, depository institutions of all sizes never know when a sudden shortfall in reserves will occur and credit won't be available. That's why Snider thinks they should establish access to the discount window before something happens. Lending agreements have been executed in just a few days during emergencies, but it is generally "not a quick process."

As of January, more than three-quarters of the Fifth District's 422 commercial banks had lending agreements with the window. But less than half of the region's 96 savings banks and only 11 percent of its 764 credit unions have such agreements (see graph on p. 3).

This brings us back to an important question—why don't more institutions use the window? One reason has been the stigma associated with window borrowing. No one is supposed to know about the transaction beyond the parties involved. However, examiners from various regulatory agencies, including the Fed, periodically review all of the loans on a bank's balance sheet. Therefore, bank officials have hesitated about using the window too often because it might serve as a red flag.

Also, the banking industry can often tell when someone borrows from the window, which can raise questions about the institution's financial strength. "If a large institution is in the marketplace looking for a large volume of money and all of a sudden it drops out, there is an assumption that it went to the window, especially if within that district there was a large amount of borrowing reported for that week," says Snider.

Another reason why depository institutions have been reluctant to borrow from the discount window is the time and effort involved with the application process. Also, it may take time for window staff to assess the borrower's collateral. Some forms of collateral are straightforward to evaluate, such as U.S. Treasury and agency securities, and investment-grade debt issued by state and local governments. But consumer and commercial loans can take longer to review, as well as new

types of securities that the Richmond Fed hasn't dealt with before.

Last October, the Federal Reserve's Board of Governors approved changes to address the issues that have been blamed for discouraging appropriate use of the discount window. These changes went into effect Jan. 9.

The Fed eliminated the window's adjustment credit and extended credit programs. The former loaned reserves on a short-term basis while the latter provided loans over a longer time period, but only under exceptional circumstances. (The seasonal credit program wasn't changed.)

Two new programs have taken their place. Primary credit is extended for very short terms like adjustment credit, but Federal Reserve Banks must charge a discount rate that is above the federal funds rate. Secondary credit for banks that don't qualify for primary credit must be priced even higher. (In January, the discount rate for primary credit was 100 basis points above the Fed's target for the federal funds rate, while the rate for secondary credit was 50 basis points higher than primary credit.) Previously, adjustment credit was priced at the discount rate, which has been consistently lower than the federal funds rate since 1990.

Pricing window credit above the market rate is intended to create an economic disincentive for excessive borrowing, which is how many central banks operate their discount windows. This will substitute for what George Kaufman calls the Fed's "gentle persuasion" and scrutiny of borrowers. Fewer questions, if any, will be asked when a borrower comes to the discount window. Any financially sound institution can obtain credit for any purpose. Also, borrowers are not required to exhaust all market sources before utilizing the window.

The Board of Governors also approved these changes to address the perception that banks resort to window borrowing only when they are in financial trouble. Plus, it wanted to make borrowing administratively easier.

In 1980, Congress allowed depository institutions that weren't members of the Federal Reserve System to borrow from the window. But in 1991, in the aftermath of the 1980s S&L crisis, lawmakers restricted borrowing by banks that didn't meet minimum capital requirements. "Discount window borrowing was providing capital for banks that were basically insolvent," notes economist Anna Schwartz of the National Bureau of Economic Research. "That was not what the Federal Reserve Act of 1913 intended the window to be used for."

What will be the role of the discount window in the future? Most economists agree that the financial markets need a back-up source of liquidity during emergencies. However, others argue that the window has little value as a monetary policy tool as long as the Fed can use Open Market operations to influence the supply of money and credit.

Of course, that could change if the federal government stops its deficit spending and resumes generating surpluses. "If we ever ran a series of surpluses and reduced the amount of government debt," says Allan Meltzer, this might leave fewer government securities for the Fed to buy and sell in its Open Market operations. "There would have to be another mechanism." **RF**

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Budget Deficits and Interest Rates

BY AARON STEELMAN

During the late 1990s, the federal budget went into the black for the first time in more than two decades. Indeed, mounting surpluses were projected for as far as the eye could see. But in 2002, as revenues began to flow into Washington more slowly and expenditures continued to rise, those black figures turned red. No one knows for sure, of course, when this will change. But it seems likely that federal budget deficits will be the norm for at least the near future.

Changing fiscal conditions have reignited a debate among economists: Do budget deficits cause long-term interest rates to rise? Unfortunately, there is no consensus on this issue.

"Despite a long history of analysis of fiscal policy, there is much less solidly based knowledge than one would like about the effects of government deficits on the economy," notes Gerald Dwyer Jr. in an article in the *Journal of Money, Credit and Banking*.

For years, the conventional view was that government debt leads to increases in long-term interest rates, which decrease capital formation, which ultimately leads to lower real income. How might public debt fuel higher long-term interest rates? The relationship "seems a trivial application of supply and demand," Dwyer writes. "If the deficit increases, the supply of government bonds increases; everything else the same, the price of government bonds falls and the interest rate rises."

There is some evidence to support the claim that deficits do, in fact, raise long-term interest rates. In a recent paper, Thomas Laubach, an economist at the Federal Reserve's Board of Governors, wrote that the "estimated effects of government debt and deficits on interest rates are statistically and economically significant: a 1 percentage point increase in the projected deficit-to-GDP ratio is estimated to raise long-term interest rates by roughly 25 basis points."

But the positive correlation between budget deficits and higher long-term interest rates doesn't always hold up under empirical testing. "There are three periods during which the federal deficit has exceeded 10 percent of national income. In none of these periods did interest rates rise appreciably. Regression analysis applied to data from these three periods has not uncovered a positive association between deficits and interest rates," writes Paul Evans in a paper published in the *American Economic Review*. "There also appears to be no evidence for a positive association between deficits and interest rates during the postwar period. I conclude from this survey that the con-

cerns of the popular press and many economists may be misplaced." Likewise, Charles Plosser has been unable to find a positive correlation between public debt and higher interest rates in two papers for the *Journal of Monetary Economics*.

The reason why some researchers have been unable to find such a correlation might be explained by the "Ricardian equivalence" theorem. This theorem is based on the notion that people are far-sighted and view deficits as simply postponed tax liabilities, which they will eventually have to pay.

"The Ricardian equivalence theorem can account for the tenuousness of any relationship between government debt and

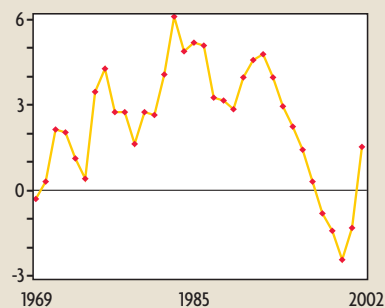
the interest rate. Under certain conditions, an increase in the supply of government debt that is not acquired by the Federal Reserve and that finances a nondistortionary change in taxes does not affect the current and expected future opportunity sets of private agents," writes Dwyer. "Hence, private agents' current and expected future consumption are unchanged, the increase in private saving exactly equals the increase in the deficit, and the increase in the demand for government securities exactly equals the increase in the supply of government securities."

Robert Barro has become perhaps the leading proponent of the Ricardian equivalence theorem, first in a 1974 paper for the *Journal of Political Economy* and now in his textbook, *Macroeconomics*.

None of this means that we should necessarily stop worrying about budget deficits. First, as Laubach's paper demonstrates, the evidence isn't as clear cut as proponents of the Ricardian equivalence theorem might claim. Second, even if budget deficits do not lead to higher interest rates, they are often the result of unwise government spending — spending that itself can produce distortions in the economy. Such spending should be avoided, no matter its effects on interest rates.

In the end, the issue of whether it may be desirable, under certain circumstances, to run budget deficits involves more important questions than how those deficits will affect interest rates. It involves setting national priorities. For instance, we may, as a country, be willing to tolerate budget deficits in order to finance an important military campaign, as we did during World War II. Likewise, we may decide that it is desirable to run up some debt to pay the transition costs necessary to privatize the Social Security system. These are issues on which economics can shed some light. But they can't be answered by economic analysis alone. **RF**

Federal Budget Deficit as a Share of Gross Domestic Product*



*Includes "off-budget" items, such as Social Security
SOURCE: Office of Management and Budget

IN THE RED

Pressure on Local Blood Markets

Had a tattoo done recently? Visited the United Kingdom for more than a few months between 1980 and 1996? Prospective blood donors who answer “yes” to these questions could be temporarily disqualified because they could harbor certain infections.

Such screening is necessary to reduce the spread of disease, but it also reduces the donor pool. Meanwhile, blood usage continues to climb due to the increasing quantity and complexity of surgical procedures, notes Dr.

Jonathan Waters, a blood conservation advocate who directs autotransfusion services at The Cleveland Clinic Foundation in Ohio. These are just a few factors that have contributed to regular shortages in some communities.

Blood is perishable — red blood cells last only six weeks refrigerated — so ensuring that hospitals always have the right amount is difficult. The quantity

demanding by local hospitals remains steady during the year, with occasional jumps in emergencies. But the quantity supplied fluctuates because it depends on the

level of donations.

For instance, fewer donors give blood during the summer and the holiday season. The Southeast is no exception, even though it ranks near the top in terms of number of blood banks, says Marian Sullivan, executive director of the National Blood Data Resource Center. “The region tends to be challenged in supplying red blood cells during the months that are typically lower for donations.”

Also, bad weather can keep donors away. East Coast storms last winter reduced blood collection in parts of North and South Carolina, leaving some blood banks with only a day’s supply.

Even on sunny days, blood shortages can develop in some areas while surpluses are occurring elsewhere. For example, Sally Foister says that her organization, The Blood Connection Inc., collects enough blood for the eight counties it serves in upper South Carolina and Georgia. But Virginia Blood Services imports 15,000 units a year to supplement what it collects for hospitals in central Virginia.

Economist Paul Haas of Bowling Green State University offers some possible explanations for differences in local blood markets. On the demand side, metropolitan areas with denser populations and regions with well-known hospitals usually need more blood. On the supply side, some blood banks are better at solicit-



Virginia Blood Services processes donations, then sends them to Dallas for testing.

ing donors than others.

It’s hard work to win the hearts — and blood — of potential donors. Foister says some people dislike needles, while others loathe answering personal questions during the screening process. Yet blood banks don’t pay for blood because they worry about attracting too many people from the low-end of the socioeconomic scale. “You would get more donors through your doors that are at a higher risk of being deferred,” notes Foister.

More importantly, individuals don’t have to donate to a blood bank to benefit from it during times of need. “People say, ‘I don’t need to do it because somebody else will,’” explains Haas. “This is a basic economic principle called the ‘free rider syndrome.’”

Blood markets illustrate another economic rule — when prices rise, buyers normally curb their consumption. As the increased cost of screening has been passed along to hospitals, medical researchers have found ways to reduce the need for transfusions and to recover lost blood.

Facts About America’s Blood Supply

► Collection centers accounted for 93 percent of the 15 million units of whole blood and red blood cells donated in 2001. The American Red Cross is the single largest collector, with community blood banks like Virginia Blood Services, The Blood Connection, and hospitals accounting for the remainder.

► U.S. hospitals transfused nearly 14 million units of whole blood and red blood cells to 4.9 million patients in 2001. The volume of blood transfused is increasing at a rate of 6 percent a year.

SOURCE: National Blood Data Resource Center, Food and Drug Administration

Anticoagulants like heparin reduce bleeding during surgery, while lasers seal off blood vessels as they cut tissue. Blood suctioned from the surgical field is filtered and packaged for reuse instead of being discarded.

Blood conservation has made a big difference with certain surgical procedures, according to Dr. Waters. A liver transplant performed a decade ago would have required 200 to 300 units of blood. The same procedure requires only two to three units today.

A widespread reduction in blood usage would require changing how doctors practice medicine, notes Dr. Waters, but it also would save money and improve surgical outcomes. "Patients [who receive fewer transfusions] generally experience lower operative infection rates and shorter hospital stays, which gives hospitals more available beds."

—CHARLES GERENA

RESERVISTS DEPLOYED

Businesses Hold Own — Fill Voids

The call-up of reservists over the past several months hasn't had much effect on business operations, or has it? The answer depends on whom you ask.

Large businesses shuffled workloads or hired temporary workers to cover responsibilities while those serving were gone. "At Capital One, the call-up peaked in late February and early March," says Hamilton

Holloway, media relations manager at the financial services company. "Each area pulled together and spread out the work."

Small businesses and the self-employed had a much harder time filling the void. But few reservists own their own companies. A 2000 survey by the Department of Defense (DOD) indicated that, of the 75 percent of reservists who work in civilian jobs, "30 percent of reservists worked for government at the federal, state, or local level; 63 percent worked for a private sector firm; and 7 percent were self-employed or worked without pay in their family business or farm."

Businesses are required by law to rehire those who serve in the reserves and National Guard. Yet many went one step further and made up any difference between military and civilian wages.

As of April 16, approximately 25,000 National Guard members and reservists were deployed from the Fifth District, according to the DOD. "The reservists' numbers are so small that they're not having an impact on employment," says William Metzger, chief economist at the Virginia Employment Commission. The latest figures show a slight drop in civilian employment in the Hampton Roads area — which has a large military presence — but some of that is due to the absence of full-time military personnel who were moonlighting in civilian jobs, according to Metzger.

While companies have seemed to handle personnel shortages well for now, the need for reservists has not necessarily ended. The verdict is still out as to whether longer or multiple call-ups may adversely affect business operations in an already sluggish economy.

—ELAINE MANDALERIS

WATER RESOURCES UPDATE

Rainfall Cures Drought, But Other Issues Remain

After much of the Fifth District suffered from drought last summer, above-average precipitation in the fall and winter months replenished reservoirs and helped communities remove water-use restrictions. As usual with Mother Nature, however, her bounty was a mixed blessing.

Drought conditions had plagued the region periodically since 1998. Therefore, it would take many more months of heavy rain to make up for the deficits accumulated over that period, notes Gloria Forthun, regional climatologist for the Southeast Regional Climate Center.

Still, the fall and winter deluges helped alleviate the region's long-term drought. State officials in Virginia, Maryland, North Carolina, and South Carolina have indicated that groundwater sources are being replenished. "The Southeast is fairly lucky because the recharge rate is faster than in other parts of the country," explains Forthun.

"When we have rains like this, groundwater sources are quick to respond."

While the rainfall helped groundwater levels recover in the Fifth District, it was too much at the wrong time for the region's agriculture industry. "We've gotten too much rain," notes H. V. Mangum, information coordinator at the North Carolina State Office of the federal Farm Service Agency. "The fields are so wet that farmers have had to wait to plant their crops for 2003."

Wet conditions delayed the planting of tobacco and peanuts in the Tar Heel State by several weeks and prevented tobacco planters from fumigating their land.



Winter storms helped replenish reservoirs, enabling communities to remove water-use restrictions.

Some farmers in South Carolina also couldn't tend to their soggy fields. The only "crops" that appear to have benefited from all of the rain are pastures, which had been dry for years. Now, there is more food for poultry and cattle.

While communities cope with the abundance of rain, they're continuing to struggle with the financial fallout of the five-year drought. In April, Gov. Mike Easley

approved \$432,000 in grants to Statesville and Eden in North Carolina to reimburse them for increased spending on their water supplies. Likewise, Mangum says his agency is still providing financial assistance to drought-stricken farmers.

Ultimately, the legacy of the five-year drought is that it “woke everybody up,” says Forthun, prompting state and local officials to re-evaluate their management of water resources.

—CHARLES GERENA

ECONOMIC FREEDOM

Report Measures Impact of Government Regulation on Free Markets

What influences economic prosperity and growth? That’s the \$64,000 question for development officials and business leaders. Their answers range from proximity to transportation to the availability of relocation subsidies.

In a 2002 report, The Fraser Institute in Canada and the National Center for Policy Analysis in Dallas, Texas, explored another set of influences on business activity. They used a 10-point scale to score U.S. states and Canadian provinces on their “economic freedom,” or how much government interferes with the ability of buyers and sellers to make mutually beneficial transactions.

“The freest economies operate with a minimal level

How the Fifth District Stacks Up

Scores on All-Government Index, 2000

	SIZE OF GOV'T.	LEVEL OF TAXATION	LABOR MKT. FREEDOM	TOTAL SCORE	NATIONAL RANK
Maryland	6.9	5.8	6.1	6.3	41
North Carolina	8.1	6.3	6.7	7.0	15
South Carolina	7.0	5.8	8.1	7.0	15
Virginia	6.9	6.2	6.5	6.5	35
West Virginia	5.4	4.8	6.5	5.6	50

NOTE: Scores are based on a 10-point scale, with 10 being the best score for a particular set of economic freedom variables.

SOURCE: “Economic Freedom of North America,” The Fraser Institute/National Center for Policy Analysis, 2002

of government interference, relying upon personal choice and markets to [determine] what is to be produced, how it is to be produced, how much is produced, and for whom production is intended,” wrote Amela Karabegović, Fred McMahon, and Dexter Samida in the report. “As government imposes restrictions on these choices, the level of economic freedom declines.”

Some would argue that it’s the government’s responsibility to intervene in the marketplace when businesses aren’t playing fair or producing desirable goods and services such as parks. “While government can fulfill useful roles in society, there is a tendency for [it] to undertake superfluous activities as it expands,” argues the report’s authors. “Government spending ... reduces economic freedom once [it] exceeds what is necessary to provide a minimal level of protective and productive functions.”

Since the size of government influences economic freedom, it was one of the variables analyzed in the report. The authors also analyzed the level of taxation in

communities and legal requirements on labor markets, including minimum wage laws and occupational licensing. The result was economic freedom scores for U.S. states and Canadian provinces for each year between 1981 and 2000.

Over that period, Maryland, North Carolina, South Carolina, and Virginia improved their scores on an all-government index, which captured the effects of federal, state, and local government activity on economic freedom. Maryland improved the most, going from a score of 4.8 in 1981 to 6.3 in 2000.

West Virginia’s score on the all-government index didn’t improve, however. Fred McMahon, director of the Centre for Trade Globalization Studies at The Fraser Institute, says the Mountain State’s score for size of government “came behind six provinces, which is remarkable given how much smaller government is on average in the United States.” The state’s taxation score was a little better, coming ahead of most Canadian provinces and one state. “On the labor market

side, West Virginia comes ahead of all provinces and at least some states, though it remains in the bottom third of the rankings.”

While many factors affect local economies, McMahon and the report’s other authors found that states like West Virginia with a low level of economic freedom tend to be less wealthy, on a per capita basis, than their neighbors. This link also has been demonstrated by The Fraser Institute’s *Economic Freedom of the World* studies, which have scored nations around the globe for the last 20 years.

—CHARLES GERENA

TRAVEL AND TOURISM INDUSTRY

Fifth District Does Well in a Difficult Year

For the travel and tourism industry, 2002 was a challenge, to say the least. “We had to battle a recession, the aftereffects of the Sept. 11 terrorist attacks, the threat of terrorism, and conflict in the Middle East,” recounts Greer Beaty, director of public

relations for the North Carolina Division of Tourism, Film, and Sports Development. "These factors have influenced people to take shorter trips, stay closer to home, and drive rather than fly."

In response, tourism officials in the Fifth District have focused on strengthening their existing market of regional travelers. "Our advertising focused more on close-in markets to encourage people in the suburbs to make a trip to Washington, D.C.," says Rebecca Pawlowski, media relations manager of the city's Convention and Tourism Corporation.

In recent years, fewer people have flown in and out of the United States. Overseas arrivals dropped 12.3 percent in 2001 and 8.3 percent in 2002, while overseas departures fell 6 percent in both years. Security concerns weigh heavily on everyone's minds, while apprehension over the state of the economy weighs on wallets and checkbooks.

State travel and tourism markets have weathered these changes differently. Those that rely on air traffic, foreign visitation, or business travelers have faced greater challenges, while those with mostly regional tourists have done better. Much of the Fifth District fell into the latter category, according to state tourism officials.

Traditionally, most travelers to the region arrive by car, ranging from about 50 percent of travelers in the District of Columbia to 95 percent in West Virginia. Visitors tend to come from within the region and north-

ern states like New York.

As a result, tourism officials in the Fifth District say they have fared relatively well during the travel downturn. Several states managed to increase their visitor flow in 2002, including North Carolina (up 3.2 percent), Virginia (up 6.4 percent), and West Virginia (up 8.5 percent). Maryland and the District of Columbia saw slight declines in visitation for 2002 (down 1.6 percent and 3.6 percent, respectively). (South Carolina hadn't released their 2002 numbers as of press time.)

Officials aren't sure how much of these increases were due to people choosing domestic destinations over foreign travel. But they're confident that focusing on travelers within driving distance paid off. "Our equity in these markets came to fruition when people wanted to drive more," notes Martha Steger, public relations director at the Virginia Tourism Corporation.

Some states will continue to focus on regional tourism, partly because of the challenges of developing air service in small markets. "We fish where the fish are," notes Chris Canfield, West Virginia's tourism and marketing director. Others are widening their net, though. Virginia wants to attract Europeans to the state during Jamestown's 400th anniversary in 2007, while North Carolina hopes that the centennial of the Wright Brothers' flight in Kitty Hawk will be a global draw this December.

—CHARLES GERENA

PAYING AT THE PUMP

War, Winter, and Unrest Spike Gas Prices

As prices fluctuated last spring, spiking up to an average price of about \$1.71 per gallon at the pump just about the time U.S. troops invaded Iraq. It wasn't just wartime uncertainty that helped drive prices, though. Contributing to the price hikes were an abnormally cold winter, especially in the Northeast, and a strike in Venezuela, which provides 10 percent of the United States' crude oil. Civil unrest in Nigeria has also constricted supply, as oil companies have pulled out personnel because of fears for personal safety.

"There are still a lot of 'ifs' out there," says Lon Anderson, director of public and government relations for AAA Middle Atlantic. In late April, the Organization of the Petroleum Exporting Countries increased its production quotas. Also, the United States is working to return Iraqi oil fields to full production.

Summer gas prices are expected to average \$1.46 per gallon, 7 cents higher than 2002 summer prices and above the average of 2000 and 2001, according to the Energy Information Administration's short-term energy outlook.

Price increases typically are passed on to the consumer, says Anderson. "The tough thing about oil and gas prices is they're a component of virtually every-

thing — clothing, food, everything that comes to market has a price built in."

Gale Ellsworth, president and CEO of Fairfax, Va.-based Trailways Transportation System, says the firm's charter bus companies offset the fuel costs.

"When they price those trips, they calculate in a surcharge for increased fuel prices," she says. "And scheduled route operators are buying in bulk, but they have to pass along the rate hike to the passenger as well." Typically, the sur-



Trailways Transportation System's charter bus companies use a surcharge to offset increased fuel costs.

charge is roughly the same percentage as the price increase, she says. The charge is removed when prices drop, she notes.

Someone has to absorb the price increase. Pity the poor pizza delivery driver, though. Pie Works of Greensboro, N.C., says its pizza prices are stable and its delivery drivers, who use their own vehicles and are paid a per-trip fee, have absorbed the increase.

Oh well, maybe they get good tips.

—BETTY JOYCE NASH

Asset Bubbles

BY AARON STEELMAN

A “bubble,” as defined by economist Charles Kindleberger, is a “sharp rise in price of an asset or range of assets in a continuous process, with the initial rise generating expectations of further rises and attracting new buyers.” This, writes Kindleberger, is “usually followed by a reversal of expectations and a sharp decline in price often resulting in financial crisis.”

Many observers say that we witnessed such a bubble during the late 1990s, as the prices of stocks — particularly the stocks of high-tech companies — shot up dramatically, well beyond what economists refer to as their “fundamental value.” Most of those stocks’ prices dropped sharply a few years later, and investors paid the price for failing to base their decisions on sound financial analysis. Or so the story goes.

The facts of this case are undeniable, of course. Equity prices did, in fact, skyrocket and then plummet. But was this an example of a bubble? More fundamentally, can bubbles exist at all?

At least one economist has questioned whether you can ever be sure that an asset bubble has existed. One cannot distinguish between hypotheses that asset prices are driven by a “speculative bubble and that researchers have not adequately measured the future market fundamentals anticipated by market participants,” writes Peter Garber. “More generally, data will not distinguish between a claim that market participants suffer from some mania because behavior does not conform to the prediction of some researcher’s theory and a claim that the theory is flawed or misspecified. Because of this observational equivalence, economists who take a position in the debate over the existence of bubbles are making a commitment that cannot be based on the analysis of experience.”

Garber analyzes perhaps the most famous of all supposed bubbles: the “tulipmania” that gripped the Netherlands during the 17th century. The Netherlands’ well-developed markets permitted entrepreneurs to experiment and create new varieties of flowers. Those tulip bulbs that produced unique, beautifully patterned flowers commanded high prices. More common tulips were sold at much lower prices. Prices for rare tulips, such as the Semper Augustus bulb, remained high from 1634 through early 1637. But in February 1637, prices collapsed and bulbs could not be sold at 10 percent of their peak values.

“A standard pricing pattern arises for new varieties of flowers, even in modern markets. When a particularly prized

variety is developed, its original bulb sells for a high price. As the bulbs accumulate, the variety’s price falls rapidly; after less than 30 years, bulbs sell at their reproduction cost,” writes Garber. Such a pricing pattern raises two questions about the period 1634 to 1637. First, why did the price of bulbs rise so quickly? Second, did prices decline faster than should have been expected?

Garber attributes the rapid increase in price to a general appreciation of the beauty of rare tulips by the wealthier citizens of the Netherlands. They were simply willing to pay a lot to obtain the status of owning a renowned tulip. You might think this is foolish, but it is not necessarily irrational, from the point of view of the buyer.

As for the drop in prices, the average annual rate of depreciation from February 1637 to 1642 was 32 percent. This might seem like a lot. But Garber also looked at data from the early 1700s and found that the average annual rate of depreciation for flowers during this period was 28.5 percent. It is true that these latter prices fell from a much lower peak. Still, the evidence is not compelling that the drop in prices following “tulipmania” was more severe than should have been expected.

Finally, Garber writes that “there is no evidence of serious economic distress arising from the tulipmania. All histories of the period treat it as a golden age in Dutch development.”

All this leads Garber to conclude: “Fascinated with the brilliance of grand speculative events, economists have huddled in the bubble interpretation and have neglected an examination of potential market fundamentals.” In short, those who bought tulips at the peak of the market were not necessarily careless or irrational.

Garber has staked out the most extreme position on the question of when an asset bubble occurs by stating that you can never know for sure. One might consider relaxing his assumption that all traders are rational and instead look at what happens when just some groups behave rationally, as economist J. Bradford DeLong and several of his colleagues have done. Such models may be able to help explain swings in asset prices. Nevertheless, the next time someone brings up an example of a supposed asset bubble, it might be useful to think carefully about the implicit theory behind that claim before reaching a judgment.

RF



The Economics of...Sumo Wrestling

BY AARON STEELMAN

If you asked a random person on the street what economists study, you might get a response like inflation or unemployment. The reason is pretty clear: such macroeconomic issues are crucially important and do, in fact, occupy the attention of many economists, including those in the Federal Reserve System. But there is a group of microeconomists who are grappling with many issues beyond what is normally thought of as the purview of economics—issues such as crime, divorce, and abortion, among others.

The pioneer in this regard is University of Chicago economist Gary Becker. Among his best-known books are *The Economics of Discrimination* (1957), *The Economic Approach to Human Behavior* (1976), and *A Treatise on the Family* (1981). These books apply the tools of economic analysis to issues that had long been studied almost exclusively by sociologists and psychologists.

For instance, in *A Treatise on the Family*, Becker looked at parents' "demand for children." He used "the price of children and real income to explain, among other things, why rural fertility has traditionally exceeded urban fertility, why a rise in the wage rate of working women reduces their fertility, why various government programs ... have significantly affected the demand for children, and why families with higher incomes have had more children, except during the past 150 years in Western and developing countries."

Not surprisingly, many noneconomists attacked Becker's work. It was, they maintained, inappropriate to use "rational choice" analysis to think about such intimate personal issues. People are not always cold, calculating utility maximizers, the critics charged.

In the last 20 years, the practice of "economic imperialism" has burgeoned, as many younger microeconomists have followed Becker's lead to explore new and exciting topics. One of the best examples is Steven Levitt, also of the University of Chicago. Levitt was recently awarded the John Bates Clark Medal, which is given to the nation's most outstanding economist under the age of 40, for his work on crime, corruption, and education. Among his most cited—and criticized—recent papers are "The Impact of Legalized Abortion on Crime" and "An Economic Analysis of a Drug-Selling Gang's Finances," both published in the *Quarterly Journal of Economics*.

In the December 2002 issue of the *American Economic Review*, Levitt and co-author Mark Duggan took on an issue that has long been of interest to some sports fans, but which few economists have even considered: corruption in sumo wrestling.

"The key institutional feature of sumo wrestling that makes it ripe for corruption is the existence of a sharp non-linearity in the payoff function for competitors," the authors write. A sumo tournament involves 66 wrestlers competing in 15 bouts each. A wrestler who has a winning record—that is, who has won at least 8 of his 15 matches—is guaranteed to rise in the rankings, while a wrestler who has a losing record is destined to fall. A wrestler's rank determines his prestige, salary, and the perks that he enjoys. For instance, the lowest-ranked wrestlers must rise early each morning to clean the building and prepare meals.

There is a strong incentive, then, to achieve that eighth victory in a tournament. "The critical eighth win ... garners a wrestler approximately 11 spots in the ranking, or roughly

four times the value of the typical victory. Consequently, a wrestler entering the final match of a tournament with a 7-7 record has far more to gain from a victory than an opponent with a record of, say, 8-6 has to lose," Duggan and Levitt write. "We uncover overwhelming evidence that match rigging occurs in the final days of sumo tournaments.

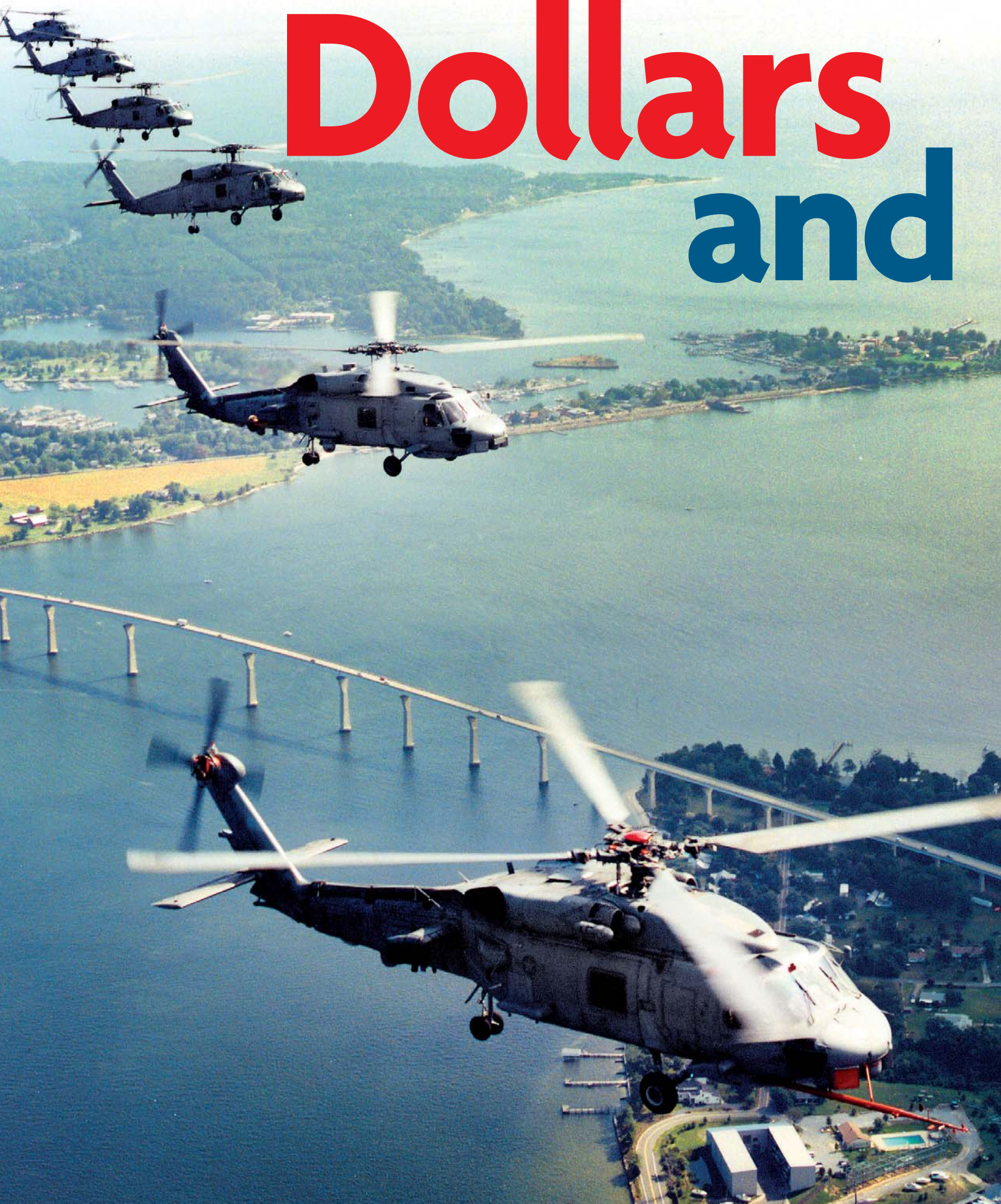
Wrestlers who are on the margin for attaining their eighth victory win far more often than would be expected."

Duggan and Levitt admit that high winning percentages among wrestlers with seven victories is not proof positive of corruption. After all, wrestlers may simply try harder in these important matches because the benefits of winning are larger. But the authors offer evidence against this alternative hypothesis. For example, while the wrestler who is on the cusp of winning his eighth match wins with surprisingly high frequency, the next time he is paired against that same wrestler he usually loses. "This result suggests that at least part of the currency used in match rigging is promises of throwing future matches in return for taking a fall today." Duggan and Levitt also tested their data against claims made by two former wrestlers against specific competitors charged with rigging matches. Their statistical analysis confirmed the whistle-blowers' stories.

One might say, "All of this is interesting. But what does it have to do with economics?" Duggan and Levitt anticipate such criticism. They write: "The success of our study in documenting the predicted patterns of corruption in one context raises the hope that parallel studies with more substantive economic focus may yield similar results." **RF**

"Winning Isn't Everything: Corruption in Sumo Wrestling," by Mark Duggan and Steven D. Levitt. *American Economic Review*, December 2002, vol. 92, no. 5, pp. 1594-1605.

Dollars and



*A Closer Look at How
Military Spending Affects
Fifth District Communities
in Times of War and Peace*

Defense

BY CHARLES GERENA

On a sunny yet brisk Wednesday in Virginia Beach, Va., the lunchtime rush hits Lynnhaven Mall. It seems busy for the middle of a workday, with the usual mix of young mothers, teenagers, and seniors eating at the food court or window-shopping.

But business is slower than usual according to one of the mall's vendors. A big chunk of the usual crowd is missing—the men and women stationed at Naval Air Station Oceana about a mile away. Approximately three-quarters of Oceana's squadrons were deployed to the Middle East at the start of Operation Iraqi Freedom. That's roughly 3,400 personnel, or one-third of Oceana's military population.

During times of war when countless families are without their dads or moms, it's easy to see the role that military installations have within communities in the Fifth District. But it's important to step back and look at the peacetime effects as well. A hefty amount of payroll and procurement dollars steadily flows

SH-60 Sea Hawk helicopters from one of Naval Air Station Patuxent River's test squadrons fly in formation near the mouth of the river. NAS Patuxent River accounts for one-third of the jobs in St. Mary's County, Md.

from the Pentagon into the Fifth District — \$44.5 billion in fiscal year 2001 alone. How those dollars are spent — and the economic activity that they generate — can differ significantly from community to community.

The Fifth District's Defense Establishment

The armed forces have amassed a significant physical presence throughout the South and West. In the Fifth District alone, installations in Virginia, Maryland, and the Carolinas house 398,500 military and civilian personnel, or one-quarter of the national total. (See map and table on p. 14.)

Economists offer several possible explanations for the Pentagon's regional preferences. One reason is that military operations are land intensive and the South had plenty of territory ripe for development. "Army bases tend to be out in fairly isolated areas. When you are firing tanks or artillery, that doesn't make for very good neighbors," explains Lt. Col. Michael Meese, an economics professor at the U.S. Military Academy at West Point.

The Air Force and Navy also needed a significant amount of land. In addition, they found Southern states attractive for

their coastlines, which provide good launch pads for air and sea operations.

Yet not every state in the South or the West is saturated with military installations. That's where politics have made the difference since World War II. Southern congressmen like retired South Carolina statesman Strom Thurmond "had a great deal of power in Washington," says Albert Parish Jr., director of the Center for Economic Forecasting at Charleston Southern University. Other senior lawmakers like Sen. Fritz Hollings of South Carolina and Sen. John Warner of Virginia have used their clout to encourage the location of bases in their home states.

Political influence also has steered a lot of the military's primary contracts to the Fifth District. Firms in southern Maryland, Northern Virginia, and the District of Columbia — all of which are close to key decisionmakers on Capitol Hill and at the Pentagon in Arlington, Va. — capture the lion's share of procurement dollars in the Fifth District. These states and D.C. garnered \$25.1 billion in primary contracts for fiscal year 2001, while companies in North Carolina, South Carolina, and West Virginia accounted for another \$2.7 billion.

There are other reasons why so many primary contracts are filled in the region. "One reason for the concentration of defense spending is the change in the nature of defense production," wrote Robert Atkinson in a 1993 journal article. "Since World War

II, defense procurement has focused less and less on conventional military products [like trucks and rifles] and more on aerospace and electronics products." Manufacturers of the latter products began moving from the Midwest because they felt neglected by

local governments, adds David Gold, an economics professor at New School University in New York City who studies military spending. Communities chose to focus on their traditional industries like auto manufacturing.

At the same time, rural communities in the South and West needed to replace their lagging agricultural sector. Local governments actively recruited large manufacturers, including defense contractors.

"Defense contractors moved to [these regions] because they were attracted there and the governments wanted growing industry," explains Gold. "A lot of places...attracted these companies with subsidies, tax relief, and a nonunionized labor force."

Tracking Defense Dollars on the Economic Radar

Since the military established its foothold in Fifth District communities, it has added an interesting variable to local and regional economies.

In cities and counties where a military installation accounts for the majority of economic activity, employment and income levels are subject to wide swings. "The smaller the initial community, the greater the influence that a major military installation will have," notes Dick Brockett, associate director for economic development at East Carolina University's Regional Development Institute. This is similar to the impact of a large manufacturing plant in a small town.

Naval Air Station Patuxent River, which accounts for one-third of the jobs in St. Mary's County, Md., illustrates this phenomenon. When the Navy consolidated its flight testing and development work at Patuxent River during the 1990s, numerous high-tech firms moved to this waterfront community to provide support services. This spurred the development of office space near the facility and prompted the county to revise its transportation planning. In addition, the influx of technical jobs boosted the county's median household income.

Havelock in eastern North Carolina could see similar changes in its economy if the Pentagon decides to house some

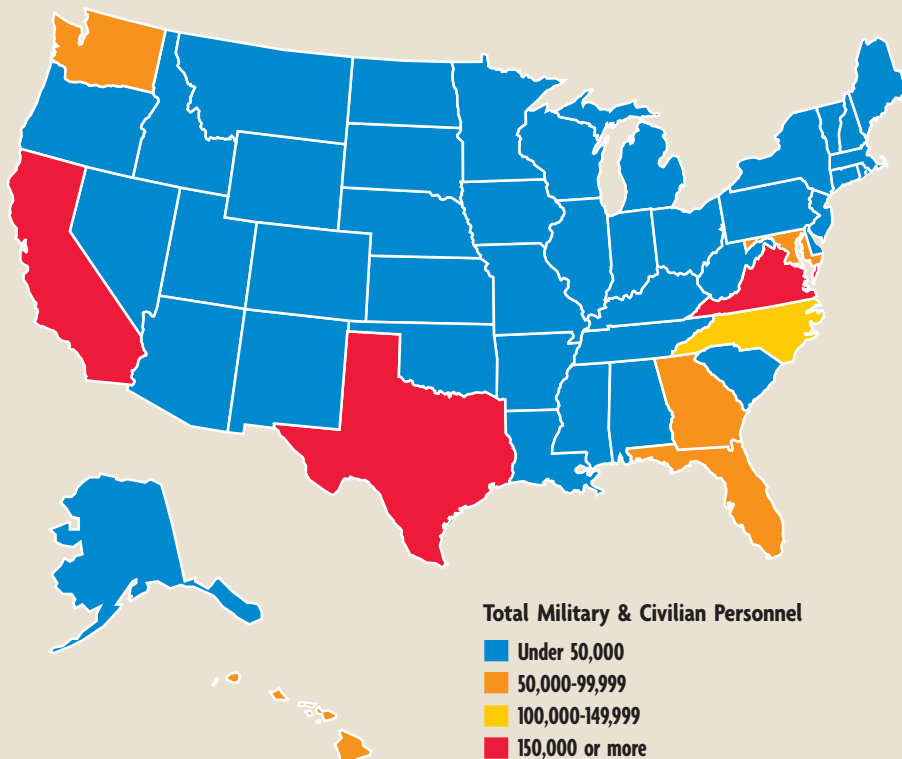
The Military's National Footprint

In the fiscal year ending Sept. 30, 2001, the states with the most active duty military and civilian personnel were in the South and West. The Fifth District alone was home to more than 398,500 personnel, most of whom were stationed in Virginia and North Carolina.

Rank	State	Military Personnel	Civilian Personnel	Total Personnel	% of U.S. Total
1	California	107,452	58,378	165,830	10.2
2	Virginia	80,613	76,246	156,859	9.7
3	Texas	113,865	37,511	151,376	9.4
4	North Carolina	85,584	16,441	102,025	6.3
5	Georgia	62,013	31,169	93,182	5.8
6	Florida	49,029	26,539	75,568	4.7
7	Maryland	29,296	31,818	61,114	3.8
8	Washington	31,833	22,511	54,344	3.4
9	Hawaii	34,958	16,699	51,657	3.2
10	South Carolina	38,552	9,349	47,901	3.0
20	District of Columbia	13,104	15,230	28,334	1.8
48	West Virginia	504	1,777	2,281	0.1

NOTE: Personnel on temporary duty may be reported at their assigned locations, not their home stations.

SOURCE: Department of Defense, Directorate for Information Operations and Reports



Life in the Civilian World

Like many retirees from the armed forces, Robert Garman likes to get together with his former comrades. They frequent the officer's club at Fort Bragg near Fayetteville, N.C., attend church services on base, and support each other during times of need. "It's like an extended family," says the 71-year-old lieutenant colonel.

The bond between former members of the military isn't the only thing that distinguishes them in the civilian world. These differences have interesting economic implications for the communities in which they reside.

Like civilian workers, military personnel look for a place to retire where the climate is pleasant, the cost of living is affordable, and recreational opportunities are available. But unlike most civilians, they tend to settle close to their former employer, Uncle Sam. Virginia and North Carolina, two states that rank among the top five states for defense personnel, are also among the top 10 states for military retirees (see chart).

Usually, retirees live within driving distance of where they were last stationed because they know the community and want stability after years of moving from place to place. They may consider relocating, as long as it's an attractive locale near another base.

"Military retirees are closely influenced by accessibility to a major military installation," noted Mark Fagan in a September 1992 report on this demographic group in Alabama, where Fagan heads the department of sociology and social work at Jacksonville State University. "Retirees and their dependents retain many of the benefits of active duty personnel." These include access to discounted goods at military exchanges and commissaries and free or reduced-cost health care at bases with hospitals or clinics.

Another thing that military people look for when they retire is employment opportunities.

They are relatively young, usually in their 40s according to Fagan's research, so they are very likely to pursue a second career.

When they re-enter the work force, military retirees bring years of work experience and specialized skills, much of which have civilian value. "They come from a big bureaucracy, so they can fit into larger organizations very well," says Fagan. "They also are familiar with organizational behavior." As a result, "they increase the labor skills of the area where they retire."

High-ranking military retirees may leverage

these assets to get a job with the Department of Defense and other federal agencies, join a defense contractor, or start their own business. Noncommissioned retirees can usually find a comparable job in industries like health care and electronics. "Because of their prior experience and the work ethic that they developed, military retirees typically get employed easily," adds Fagan.

Despite the employability of military retirees, studies indicate that retirees tend to earn lower pay than civilians with similar skills. Why this is the case is an open question among economists.

Some suggest that there are some combat positions that don't have a direct civilian counterpart, such as ordnance experts. But economist David Loughran at RAND, a think tank based in Santa Monica, Calif., believes that the difficulties of transferring certain skills and experience learned in the military isn't the whole story.

Loughran points to another potential factor — military pensions, which can be as high as 75 percent of base pay for 30 years of service. Given this income, as well as continued access to base amenities, retirees can afford to pursue lifelong dreams or interests. "Maybe what they are trying to maximize is not their earnings," surmises Loughran, but other things in their lives that are more important.

Regardless, military retirees close the income gap with civilians once their pension and allowances are combined with their salary. This buying power adds to a community's existing base of retirees, although not all of their money goes into local economies. "By and large, I buy at the commissary," says Robert Garman, echoing the buying habits of other veterans. "I pick up some stuff in between trips. If the milk runs out, I stop at the store."

—CHARLES GERENA

Homes of the Brave

Veterans of the armed forces tend to settle in states with a significant military presence, as shown in the figures below from fiscal year 2002. The one exception is the District of Columbia, which ranks in the top half of states for military personnel but finished last in terms of its retiree population.

Rank	State	Retiree Population
1	California	188,642
2	Florida	182,540
3	Texas	173,932
4	Virginia	127,784
5	Georgia	79,244
6	North Carolina	73,289
7	Washington	67,377
8	Arizona	50,022
9	South Carolina	50,009
10	Alabama	49,610
11	Maryland	46,262
41	West Virginia	9,722
51	District of Columbia	3,185

SOURCE: Department of Defense, Office of the Actuary

of its new Super Hornet squadrons at Marine Corps Air Station Cherry Point. In the meantime, however, the absence of 3,300 Marines and support personnel deployed in the Middle East earlier this year added to the economic pain of businesses in this city of 22,000 people.

In communities with a more diverse economy, growth in defense-related activity can help counter downturns in nondefense activity. For example, the

188,000 naval personnel and their family members living in the Hampton Roads region of southeastern Virginia helped the regional economy weather nationwide recessions during the early 1980s.

"We regard ourselves as having a very stable economy because we have a baseline of [defense] spending, and the volatility in that spending tends to not reinforce the business cycle," notes John Whaley, deputy executive direc-

tor of economics at the Hampton Roads Planning District Commission. "Occasionally, these cycles will come in sync and we'll suffer from downturns in both," such as in 1991 when Hampton Roads' recession was worsened when tens of thousands of troops were deployed for Operation Desert Storm. "But usually one of those cycles tends to offset the other one."

The level of diversity in a local

Troubles on the Financial Front

When soldiers are shipped out to war, sometimes with only a few days' notice, settling their financial affairs is probably the last thing on their minds. As a result, a checkbook and a pile of bills can suddenly land in a military spouse's lap.

That's what Stephanie Moore has seen from behind the counter of Express Check Advance, a payday lender near Naval Air Station Oceana in Virginia Beach, Va. Since the Middle East deployments began last March, Moore says the wives of Oceana personnel have been coming for advances on their husbands' paychecks.

Deployments are just one of the challenges that can compel military families to turn to payday lenders, pawnshops, and other high-cost sources of funds.



CHARLES GERENA/PIRE OF RICHMOND

One-quarter of the people who sell their belongings to Cash Converters are military personnel.

A significant number of soldiers occasionally stumble into a financial ditch, according to a July 2002 survey of 11,000 active duty personnel. About 33 percent of respondents of various ranks admitted they had bounced two or more checks, had overdue bills, or lost their utility services during the last 12 months. Among the privates surveyed, the percentage in financial distress climbs to 46 percent.

Poor military pay is frequently blamed for these difficulties. Congress has approved wage increases several times, including a 4.1 percent minimum increase for 2003 and a 5.5 to 6.5 percent raise for certain mid-level personnel, but soldiers still feel underpaid. About 42 percent weren't happy with their compensation, which includes base pay, allowances, and bonuses. (A private on active duty for a

minimum of four months makes a base salary of \$13,800 a year, while a sergeant with two years of experience earns \$19,500 annually.)

Pay levels aren't the only problem. "If soldiers don't know how to manage their money, no matter how much money you give them they are not going to manage it correctly," says Lillie Cannon of the National Military Family Association Inc., a nonprofit group that provides a variety of services for soldiers and their dependents.

In addition, the uncertainties of life in the armed forces add to the financial stresses on military families. There are married couples and single parents who "deal with all of the [financial matters] that you and I do, and they are doing it in an environment over which they have much less control," describes Roderick Mitchell, president of the Pentagon Federal Credit Union Foundation, a financial literacy organization.

For example, Mitchell says that single parents struggle to find daycare for their children that works with their turbulent schedules. Also, "enlisted people may have a change in duty station five or six times during their career," and each move takes a financial and emotional toll on their families.

At the same time, military personnel have financial avenues available to them that civilians don't have. These include pay advances to cover relocation costs, low- and no-interest loans from relief agencies run by veterans and volunteers, and access to credit from military credit unions.

But these avenues have their limits — a pay advance is available only once, relief agencies have guidelines for awarding loans and have limited funds, and credit unions have a fiduciary responsibility to turn down borrowers with poor financial histories.

Once they reach the end of their rope, soldiers find themselves among the many consumers who turn to payday loans. "They are young, on moderate incomes, and have moderate education levels," describes John Caskey, an economist at Swarthmore College who studies consumer finance. "Payday lenders are not looking for the desperately poor, but moderate-income people with jobs who are financially stressed."

Payday lenders offer privacy for those who worry about their superiors learning about their financial problems, which can count

against them for a promotion. They also offer convenience, since they are often near a military installation.

This brings up a point of controversy. Are payday lenders preying on the misfortunes of the military? The clustering of lenders around bases would suggest that — 10 storefronts offer cash advances within a five-mile radius of Oceana.

But Vicki Woodward of the Community Financial Services Association of America, a trade group for payday lenders, argues that if the military were such an attractive market, every lender would locate a majority of its stores near a base. This is not the case with Advance America, a founding member of the group. As of April 2003, only 17 of the company's 80 Virginia stores were located in Hampton Roads, the home for 188,000 naval personnel.

Also, less than 1 percent of Advance America's total customers are military personnel, according to company records. Its share of military customers goes up in places with more bases — 1.5 percent in Virginia Beach and 10 percent in Hampton Roads. But in both cases these percentages are smaller than the ratio of each area's military population to its total labor force.

More likely, payday lenders near bases are tapping into the broader community that includes both soldiers and civilians. "The military [presence] was not a consideration; it was the overall population," says Rob Godbey, owner of seven Cash Express locations in Hampton Roads. "We have some military that come in, but not many. They are not our focus."

On the other hand, Tim Oldfield readily admits that his company, Cash Converters United LC, opened all five of its Virginia stores in Hampton Roads because of the region's military presence. "A base's population is transient. People are coming in and out all the time," says Oldfield, who also oversees a store near Fort Bragg in North Carolina. When soldiers are reassigned or deployed at the last minute, they can get quick cash for their belongings from Cash Converters instead of paying movers or renting storage space. Also, the company's selection of second-hand goods provides newly assigned personnel with an inexpensive way to furnish their residences.

—CHARLES GERENA



The commissary is an attractive alternative for military shoppers in Virginia Beach, Va.

economy is just one factor that determines the effect of military installations. "What they do [determines] the kind of people and number of people they hire," says Barney Warf, professor of geography at Florida State University. "There is no such thing as a typical installation."

Naval ports, air stations, and other personnel-driven bases focus on training and deploying large numbers of military personnel, mostly enlisted men and women. A common view is that enlisted personnel aren't paid well, therefore their income affects a community less than their civilian counterparts in the work force.

Still, a 1999 Congressional Budget Office study found that "a new recruit's pay is greater than the pay received by roughly three-quarters of all 19-year-old male civilian workers with only a high school degree."

More specifically, the annual income of a private with one year of service — which includes base pay and allowances for food and housing — beats the average annual wage of several counties in the Fifth District with personnel-driven bases. They include Craven County in North Carolina, Lee County in South Carolina, and Prince George County in Virginia.

The inflow and outflow of enlisted personnel at a base is usually balanced. But when large-scale troop deployments occur, such as those preceding Operation Iraqi Freedom, the result can be a lot fewer people around to spend money. Some families also may move in with out-of-town relatives for emotional and financial support.

The opposite happens at bases that serve a support role during deployments — their populations temporarily increase. Charleston Air Force Base in South Carolina added personnel earlier this year to operate the C-17 cargo planes that transported supplies, equipment, and personnel to the Middle East.

The new spending that is created is fleeting, of course, and not all of it occurs locally. "The temporary personnel spend money at the hotel, eat out some, and buy gas for their car," says Parish. "Still, the majority of their salary goes back home."

Things are different at military installations with a service orientation. Bases that test new weapons, have research and development facilities, and perform back-office operations require a core group of civilian and military professionals. This group usually isn't deployed with troops, providing a stable work force of well-paid professionals.

Parish points to the Space and Naval Warfare Systems Center in Charleston. The systems integration facility pays its 1,200 workers two and a quarter times more than the city's average wage, which tends to be low due to the preponderance of tourism and other service-related employment.

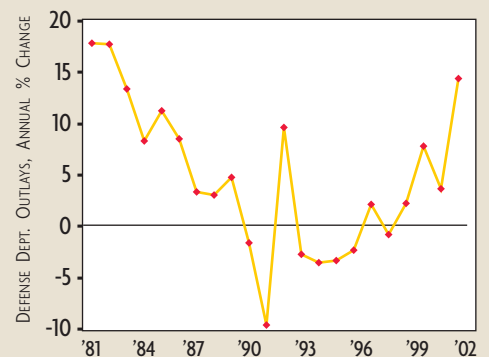
Wages vs. Weapons

Regardless of the military installation in question, its payroll directly affects a local economy more than its procurement dollars. That's because soldiers and their dependents tend to make their purchases within the community, while procurement dollars tend to leak out of the community and into the regional or national economy.

Military families buy a variety of services locally, from electricity and other utilities to health care and recreation. They are also encouraged to shop at local retailers. However, how much they spend in the civilian economy can be influenced by where they live.

The Big Guns

Annual growth in defense spending in fiscal year 2002 reached its highest peak in 20 years, as measured in real dollars. This put the military's budget over the \$300 billion mark. However, where and how the Pentagon aimed that fiscal ammunition determined the effect on Fifth District communities with a significant military presence.



SOURCE: Budget of the United States Government, Historical Tables

If a military installation provides living quarters for families, their spending may be less likely to reach civilian retailers. Commissaries and military exchanges compete well against grocers and shopping centers by being convenient and, in some cases, offering better prices. Also, private companies like Bank of America and McDonald's operate branches on bases, although some of

their sales reach the civilian economy via the salaries paid to local workers and suppliers.

If military families must live off base, however, more of their retail spending will likely occur in the surrounding community. For example, Naval Air Station Oceana only has 25 housing units for soldiers' families, so most of them reside in nearby subdivisions, according to Public Affairs Officer Troy Snead. They don't exclu-

the commissary," notes Snead.

In contrast, a personnel-driven base spends most of its money on goods supplied under national procurement contracts. These include office supplies that are needed in large quantities, and specialized parts and equipment, neither of which can be bought at the neighborhood Wal-Mart. For instance, Hampton Roads has several major shipbuilding companies that service the Navy, but Whaley says these firms and

the base's F/A-18 squadrons.

But most basic services will likely continue to be awarded through national contracts, such as transportation. "All branches of the military ... rely heavily upon shipping companies and, to a lesser extent, airlines to transport military material," noted Warf in a 1993 journal article. "Trucking companies frequently contract with the Army to haul goods overland."

Military installations that perform research and systems integration have a need for technical expertise, creating a market that may attract high-tech firms to a community. That is what Naval Air Station Patuxent River did for St. Mary's County. It's also what happened in the Charleston, S.C., area, where defense contractors employ 4,500 people to support the Space and Warfare Systems Center.

But such an agglomeration of industry requires time and support to form, so service-oriented installations often look elsewhere to fill their needs in the meantime. "The more knowledge intensive the activity and the more it involves sophisticated equipment, the more likely [it will be] contracted out of the community," adds New School's Gold.

In general, contract dollars tend to spread out widely. For example, Arlington, Va.-based CACI International Inc. utilizes subcontractors throughout the Northern Virginia region to serve a prime contract with the Naval Sea Systems Command. In addition, the company uses subcontractors from California, Indiana, Connecticut, Oklahoma, and several other states.

The Old Guns and Butter Debate

Whether they come from military installations or primary contracts, defense dollars undoubtedly generate employment and income in communities throughout the Fifth District and the nation. But in order for this to happen, capital and other resources must be diverted from civilian to defense-related production.

Such a shift isn't inherently good or bad. As Gold explains, that kind of trade-off occurs whenever capital is invested in a new economic activity. "If

In the Navy

Each summer, hundreds of young adults arrive in Annapolis, Md. Their destination is the U.S. Naval Academy, where these "plebes" will spend four years preparing for a career in the Navy or Marine Corps. While the Academy shares some of the traits of a college or university, it is not your typical institution of higher learning.

For the fiscal year ended Sept. 30, 2001, the Naval Academy spent \$304 million. Payroll accounted for about two-thirds of that total, while purchases of goods and services accounted for the remainder. These numbers may sound impressive, but economist David Gold of New School University in New York City believes that military academies in general are not as economically involved in the community as other post-secondary schools.

For example, while college students often hustle to find a job, midshipmen at the Naval Academy are under less pressure to work thanks to the generosity of Uncle Sam. Tuition and room and board are free, basic medical care is available on campus, and students have access to discounted goods at military commissaries and exchanges.

Further, midshipmen have fewer opportunities to open their wallets outside of the Academy. They spend most of their day on campus, either in the classroom or on the training field. They get holidays and short breaks called liberties, but earn additional time

off only with seniority and good performance.

Once midshipmen venture into the community, they usually have less money to spend than a typical college student does. They receive a stipend of \$764 a month, but are left with only \$75 to \$100 a month in their first year — uniforms, books, and other service charges are deducted first. In contrast, a recent poll by Harris Interactive found that college students had \$287 in monthly discretionary income.

The Naval Academy does contribute to Annapolis' economy by procuring some of its goods and services locally. For example, it spent almost \$10 million on utilities and \$10.2 million on facilities maintenance in fiscal year 2001. King Hall, which serves meals to midshipmen, spent \$16.9 million, some of which went to salaries for civilian employees and food products from local vendors.

Another part of the Academy's local impact comes from tourism. More than 1.5 million visitors come to the Academy every year. Potential students, parents, and educators attend Academy Admissions Day and Candidate Visit Weekends, while tourists stop by the visitor center to learn about the Academy's history. One of the biggest draws is when the Navy's football team plays a home game — more than 30,000 fans attended four home games in fiscal year 2001.

—CHARLES GERENA

sively shop at the huge Navy Exchange Mall near the front gate or buy groceries at the commissary because of the abundance of retail options surrounding Oceana. "If you live a block away from a 7-11 and need a quart of milk, you aren't going to drive all the way to

the region's naval facilities do most of their procurement on a national level.

Bases purchase some services locally, such as building construction and maintenance. Oceana hired W. M. Jordan Co. in nearby Newport News to expand three structures that support



C-17 cargo planes from Charleston Air Force Base in South Carolina were used to fly 3,000 tons of cargo and 400 vehicles during Operation Iraqi Freedom.

you build an auto plant in South Carolina, people who were previously looking for employment in agriculture and small businesses will line up at the gates of the plant.”

The real issue is whether the economic stimulus of defense spending outweighs the lost value of the goods and services that would have been produced if that money went into the civilian economy. “We don’t know what would have happened had [defense] funds been invested ... in the infrastructure of our country or the development of an educational system,” concludes Warf. “The opportunity costs argument never arises in debates over military spending. No other category of federal spending is immediately off limits.”

Economic activity around a military installation tends to be similar to the ancillary businesses that any large, labor-intensive enterprise attracts. This includes retail stores, housing, and health care facilities.

In addition, installations generate some economic development that would not have occurred otherwise. Some hotels cater to the military, housing reservists who train at bases on weekends, military and civilian personnel on a temporary assignment who want to avoid signing long-term leases at apartment buildings, and families vis-

iting their relatives who are graduating from basic training.

However, military officials can actively discourage development near a base. Robert Beasley Jr., who has leased industrial property in Virginia Beach for the last 10 years, recalls when the Navy purchased deed restrictions on several large parcels around Oceana. It used these restrictions to limit development to small factories, warehouses, and distribution facilities.

Beasley says naval officials didn’t want offices, retail, or other high-density development that would put a lot of people on the flight path of Oceana’s aircraft. That way, injuries to civilians would be minimized in the event of an accident, plus it would temper complaints about jet noise.

A military installation also can unintentionally discourage industrial development, according to Parish at Charleston Southern. Large employers can perceive the base as a tough competitor for a community’s most adept workers.

Some economic development officials tout the potential for defense-related research and development to produce commercial spin-offs. While such spin-offs have occurred — everything from Teflon to the Internet has its origins in the military — the commercialization process isn’t easy. Some goods and services are produced for the military to meet precise specifications and often must be able to withstand extreme conditions, regardless of the

costs involved. In contrast, commercial goods and services need to be broadly useful and profitable to produce.

Ultimately, national defense must be judged for more than its economic effects in communities. Economists describe it as a classic public good. One person’s consumption doesn’t diminish someone else’s consumption, and no one can be excluded from consuming it. Therefore, a public good benefits everyone equally and at no cost to individuals. This is why companies don’t run armies — they couldn’t make a profit.

As new challenges lie ahead for this volatile, interconnected world, lawmakers and taxpayers must decide how they value national defense as a public good as well as an economic stimulus, and how much they are willing to sacrifice in return.

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*Who should sell hard liquor in
the Fifth District — state-run
monopolies or private companies?*

Liquid Assets

BY KARL RHODES

When George Griffin was named acting director of the Department of Liquor Control in Montgomery County, Md., he received some advice from a long-time veteran of county government.

“Our director of management and budget told me ... that this is not a difficult job if you stay focused,” Griffin recalls. “Just remember that you only have two primary goals: One is to promote temperance and the other is to increase revenue.”

When it comes to the sale of alcohol, Montgomery County is a control jurisdiction — a state or local government that exercises monopoly ownership of distilled spirits either at the wholesale or retail level, and quite often both. Montgomery County, for example, has a complete monopoly over the sale of liquor, and it is the only locality in the nation that also controls the wholesale distribution of beer and wine. All other control jurisdictions leave beer and wine

sales to private companies that they license and regulate.

A control jurisdiction is “sort of a schizophrenic system,” Griffin says. “The government, in an effort to control, is actually selling alcoholic beverages to the public for a profit. On the other hand, it shows the balance that we try to reach ... offering a legal product to the public and at the same time ensuring that it’s done so in a way that doesn’t encourage risky consumption or unlawful behavior.”

The entire spectrum of alcohol regulation and control is represented in the Fifth District. Virginia and North Carolina are strict control states, while South Carolina and Washington, D.C., are among the most open jurisdictions in the nation. West Virginia franchises its retail operations to private companies, but it maintains control at the wholesale level. Maryland varies by locality.

Each of these systems traces its roots back to Prohibition. In 1933, after

Prohibition was repealed, the federal government turned the regulation of alcohol sales over to the states. Most people were glad that Prohibition was over, but they did not want to return to the proliferation of saloons they had witnessed before Prohibition.

“It was not uncommon to find one saloon for every 150 to 200 Americans, including those who did not drink,” writes K. Austin Kerr, a historian at Ohio State University. “Hard pressed to earn profits, saloonkeepers sometimes introduced vices such as gambling and prostitution into their establishments.”

To prevent that from happening again, the states devised various ways to regulate the sale of liquor. Eighteen “control states” established government-run monopolies to distribute liquor at the wholesale level, and the vast majority of these states also controlled retail liquor sales. Meanwhile, “open states” allowed private vendors to own and operate liquor stores and wholesale

Public Spirited

State and local revenues from liquor sales

State	Revenue (000)	Population (000)	Revenue Per Capita	Regulatory Status
District of Columbia	\$25,293	572	\$44.22	Open
Maryland	37,104	5,296	7.01	Mixed ^a
North Carolina	168,676	8,049	20.96	Control
South Carolina	82,164	4,012	20.48	Open
Virginia	139,449	7,079	19.70	Control
West Virginia	15,716	1,808	8.69	Control ^b
Control States Total*	\$1,821,345	78,958	\$23.07	Control
Open States Total*	\$2,794,769	202,464	\$13.80	Open
United States Total	\$4,616,115	281,422	\$16.40	Mixed

^aMaryland has both open and control jurisdictions.

^bWest Virginia privatized its stores in 1991, but continues to control wholesale distribution.

*Numbers adjusted for Montgomery County, a large control county in a mostly open state.

SOURCES: Distilled Spirits Council of the United States (2000) and the U.S. Census Bureau (2000)

operations as long as they obtained licenses and followed the rules.

No state has ever fully converted from a control state to an open state, but in 1991 West Virginia took a step in that direction by privatizing its retail liquor stores. Similar retail conversions have been considered recently in Virginia and North Carolina.

"It's an issue that comes up periodically," Griffin says. "It particularly comes up when there are difficult fiscal times. ... People are looking for revenue sources, even if it may be just a one-time infusion. ... If you can sell something off and bring in some money, somebody will put it on the table."

That's what happened during the recession of the early 1990s, when most control states switched to bailment warehouse systems that require distillers to maintain ownership of liquor inventories until the spirits leave state-owned warehouses. In essence, states generated one-time infusions of cash by selling off their wholesale inventories. They also created new revenue streams by forcing distillers to pay bailment fees to store required inventories in state warehouses. This was a bitter pill for distillers to swallow, and it significantly increased the control states' financial incentive to maintain their monopolies at the wholesale level. But maintaining control at the wholesale level is not as controversial as maintaining control at the retail level, where states sell liquor directly to consumers.

A proposal to sell Virginia's liquor stores to private operators died in last year's General Assembly, but the bill's patron, Delegate Allen L. Louderback, plans to reintroduce the legislation in next year's session.

"I don't really think we should be in the business of selling alcohol, and we're turning around and having to figure out ways to help people break their alcohol addiction," says Louderback, a Republican from Luray. "We're sending a mixed message to the public. ... I don't believe that the government needs to be in the business of running retail operations of *any* type."

Members of the General Assembly were reluctant to privatize Virginia's state-run stores last year because they "were convinced that they were going to lose all this profit," Louderback says.

"I don't think they fully understood that the profit could still be there regardless of whether we were running the stores or not."

The Virginia Department of Alcoholic Beverage Control (ABC) turned a profit of \$46.2 million last year — not counting the state's excise and sales taxes on alcohol, which generated three times again that amount.

Louderback wants to franchise the state's 271 ABC stores to the private sector in phases over five years, and he wants to limit franchise ownership to five stores for any one person or corporation. "I don't want a private monopoly any more than I want a government monopoly," he explains.

Vernon M. Danielsen, chairman of the Virginia ABC, bristles at the suggestion that small private retailers would be more efficient than his state-run monopoly. "I have 271 stores," he says. "My overhead ... to control those ... is a substantial economy of scale. And I come from the private sector. ... I think I can run ABC with the staff that we have ... as profitably as it can be run. ... And that means that all of that [profit] goes to the state."

Monopoly profit is one of two primary advantages of a control system, Danielsen says. "The other side of it is that, in a state-owned store, our employees are a whole lot more careful about who they sell to."

Virginia's underage enforcement program employs kids in their late teens who attempt to purchase alcohol at ABC stores and at licensed establishments that

Public Consumption

Gallons of liquor purchased in the Fifth District

State	Gallons (000)	Population (000)	Gallons Per Capita	Regulatory Status
District of Columbia	1,687	572	2.95	Open
Maryland	7,670	5,296	1.45	Mixed ^a
North Carolina	8,145	8,049	1.01	Control
South Carolina	5,707	4,012	1.42	Open
Virginia	6,831	7,079	0.96	Control
West Virginia	1,367	1,808	0.76	Control ^b
Fifth District Total	31,407	26,816	1.17	Mixed
United States Total	352,983	281,422	1.25	Mixed

^aMaryland has both open and control jurisdictions.

^bWest Virginia privatized its stores in 1991, but continues to control wholesale distribution.

SOURCES: Distilled Spirits Council of the United States (2000) and the U.S. Census Bureau (2000)

sell or serve beer, wine, or liquor by the drink. "At a [state-owned] ABC store, we are at least three times better than in the other stores," Danielsen says. "In an ABC store, we're between 5 and 10 percent noncompliance. At the [licensed establishments] we are at 25 to 26 percent noncompliance." Licensed establishments include restaurants, bars, and clubs that sell alcohol by the drink and stores that sell beer and wine for off-premise consumption.

Louderback counters that privatizing the liquor stores would allow Virginia ABC to focus on enforcement. "It might be better that we're not watching our own operation," he suggests. "It might even be tighter than the existing situation because ... if someone messes up and loses their franchise, they could lose a lot of money."

The market value of the proposed franchises is another point of disagreement. Louderback predicts that Virginia's existing stores would bring in about \$500 million. But Danielsen says that estimate is on the high side

— even if Virginia ABC eased restrictions on advertising, product mix, hours of operation, and store appearance. And Louderback doesn't want to relax those rules.

"As with McDonald's or Burger King or any other franchise, you can set the guidelines ... whether it's employee dress or the appearance of the store or the cleanliness of the store," Louderback says. "If they don't meet those guidelines, they could lose their franchise. I think that's a pretty big incentive to maintain a quality operation."

Maybe so, says Danielsen, but "the more restrictions you put on it — and the restrictions bring it closer to the way it's operated now — the less valuable it is."

West Virginia can shine some light on the hypothetical debate in Virginia. The Mountain State franchised its 155 liquor stores to private retailers in 1991 on 10-year contracts that generated \$22 million.

The market for store-bought spirits is about five times larger in Virginia than



it is in West Virginia, so a valuation based solely on sales would put the price of Virginia's stores at about \$110 million. But Virginia's population is growing while West Virginia's population is shrinking, and Virginia's stores are highly profitable, while several of West Virginia's stores were struggling in 1991.

"West Virginia had some problems with its retail operation," Danielsen says. "It was not very efficient, and it was not making much money."

Keith Wagner, deputy commissioner of the West Virginia Alcoholic Beverage Control Administration, also acknowledges that West Virginia underpriced some of its franchises in 1991. "In the original bidding, there was no [minimum] price attached," he says. "We sold franchises for \$100, if that was the highest bid. ... One of our biggest franchises — in Parkersburg — was originally sold, I think, for \$500."

When West Virginia re-bid the franchises in 2000, the state put a minimum price on each territory based on its average sales during the previous 10 years. Franchisees had to win new competitive bids to retain their 10-year contracts to operate liquor stores in their territories. "We gave preferential treatment to those who had already held franchises," Wagner says, but franchisees like the one in Parkersburg had to pony up. Those gains, however, were offset by lower prices for franchises in regions where the population had declined, and West Virginia again netted \$22 million for the 10-year contracts.

"Since then, we've had two or three bidding periods because we didn't sell

What About Beer and Wine?

While the regulation of liquor varies dramatically throughout the Fifth District, the regulation of beer and wine is very similar.

In control states and open states alike, beer and wine are widely available for off-premise consumption at private retailers that maintain alcohol licenses. States also license restaurants, bars, clubs, and other establishments that sell beer, wine, and liquor by the drink.

"As a general rule, there is a great disparity between what beer and wine [retailers] are allowed to do...and what distilled spirits [retailers] are allowed to do," says Dave Holliday, vice president for state government relations at the Distilled Spirits Council of the United States (DISCUS). "There is a great gap between what distilled spirits taxes are and what beer and wine taxes are."

Holliday also notes a huge difference in availability—particularly in control states, where there are only a few hundred off-premise outlets for distilled spirits, compared to thousands of off-premise stores for beer and wine. "What we work on a lot is trying to level the playing field so that beer and wine don't have such a pronounced market advantage against spirits," he says.

Control state officials argue that tighter liquor restrictions are necessary because spirits are far more potent than beer and wine. "That's the reasoning, but it's wrong," Holliday says. He notes that the standard servings of beer (12 ounces), wine (5 ounces), and liquor (1.5 ounces) contain the same amount of alcohol. And according to DISCUS numbers for 2000, residents of the Fifth District consumed nearly 20 times more beer and wine than liquor.

Per capita consumption of beer and wine are somewhat higher in Washington, D.C., and South Carolina, where alcohol-related traffic deaths are higher, but the correlation is not as dramatic with beer and wine as it is with distilled spirits.

Two bartenders interviewed for this story contend that distilled spirits *do* tend to be more dangerous than beer and wine. They note that a standard serving of beer fills up drinkers more than a typical mixed drink or glass of wine. They also note that beer and wine are more often consumed with food.

They agree with the immortal words of Redd Foxx: "Wine is fine, but liquor is quicker."

—KARL RHODES

all the stores, and we're getting ready to have another one for the remaining 14 franchises," Wagner says. That bidding period probably will dispose of five or six more stores, he predicts.

Wal-Mart has expressed an interest in bidding this time. Unlike many states, chain stores are allowed to sell liquor in West Virginia. In fact, Rite Aid is by far the largest franchisee in the state with 45 stores, the most allowed by law. Other major franchisees include Pharmor and Big Bear Super Markets.

West Virginia has not increased its enforcement efforts, and Wagner says it hasn't been necessary. "In the past 12 years that they've been out there, you can count on one hand the number of violations for underage sales," he insists. "Most of our retail operators have invested a lot of money in this business ... and they realize that they could lose their license."

Overall, Wagner believes West Virginia has come out slightly ahead by privatizing its stores. Generating \$22 million every 10 years has more than made up for agency profits that are about \$1 million less per year than they were in 1989.

Also, by selling the stores, the state was able to eliminate 500 government jobs, Wagner says. "Of course, the politicians would like to have those jobs back — those patronage jobs at the liquor stores — but I think they realize that this has been good for the private sector."

A dozen years after privatization, West Virginia doesn't seem to have a drinking problem. In fact, its residents consume less liquor (0.76 gallons per capita in 2000) than any other state population in the Fifth District, according to the Distilled Spirits Council of the United States Inc. (DISCUS).

ABC officials in other states suggest that moonshine keeps that number down, but the black market for white lightning doesn't seem to have a major impact on the state's highway safety statistics. In 2001, West Virginia had 0.68 alcohol-related traffic fatalities for every 100 million miles traveled, according to the National Highway Traffic Safety Administration. That's not quite as good as Virginia (0.46),

Maryland (0.56), or North Carolina (0.58), but it's significantly better than the open jurisdictions of Washington, D.C. (1.01) and South Carolina (1.27).

South Carolina's fatality rate is the worst in the nation. Consumption of distilled spirits in the Palmetto State was 1.42 gallons per capita in 2000, which was significantly above the national average of 1.25 gallons, according to DISCUS. South Carolina has three times as many liquor stores per capita than the Fifth District average, and there are relatively few restrictions on how these stores advertise spirits.

through the legislature, and signs are that it will," Brazell says. "Then it would go back to the legislature for ratification in 2005."

Although South Carolina has the most alcohol-related traffic fatalities in the nation, on a per capita basis, that statistic is improving. In fact, the fatality rate has declined significantly in all 50 states since 1982, improvements that corresponded with laws that raised the legal drinking age to 21. But while the national fatality rate fell 62 percent, Washington, D.C.'s rate jumped 63 percent.

Maria Delaney, director of the Dis-

Yo, Ho, Ho, and a Revenue Flow!

Who gets what from a bottle of rum?

State	Retail Price ^a	State & Local Revenue ^b	Federal Revenue	Private Sector Revenue ^c	Regulatory Status
District of Columbia	\$10.79	\$1.23	\$2.15	\$7.40	Open
Maryland	10.49	1.00	2.15	7.33	Mixed ^d
North Carolina	10.95	3.39	2.15	5.41	Control
South Carolina	11.55	1.70	2.15	7.70	Open
Virginia	11.44	4.25	2.15	5.04	Control
West Virginia	11.09	2.64	2.15	6.29	Control ^e
Control States Average	\$11.25	\$4.08	\$2.15	\$5.02	Control
Open States Average	\$11.57	\$1.58	\$2.15	\$7.83	Open
National Average	\$11.49	\$2.19	\$2.15	\$7.15	Mixed

^aPrice and tax rates are for a 750-milliliter bottle of 80-proof rum.

^bIncludes state and local taxes in each state plus wholesale and retail markups in control states.

^cIncludes indirect taxes paid by the private retailers and wholesalers.

^dMaryland has both open and control jurisdictions.

^eWest Virginia privatized its stores in 1991, but continues to control wholesale distribution.

SOURCE: Distilled Spirits Council of the United States, Bottle Tax Burdens (2001)

Another possible factor is the state's use of mini-bottles to serve liquor by the drink. South Carolina is the only state in the nation that requires bars and restaurants to pour distilled spirits from mini-bottles, says Danny Brazell, public affairs director for the South Carolina Department of Revenue.

"One of the reasons why some groups are looking to change the law is because they think that when [liquor] is served this way, the consumer is more apt to drink too much," Brazell says. A mini-bottle holds 1.7 ounces of spirits, while a standard shot contains 1.5 ounces.

Changing the law would require an amendment to the state constitution, which must be approved by voters. The earliest possible referendum date "would be November 2004, if this gets

trict's Alcoholic Beverage Regulation Administration, declined to speculate on why D.C.'s fatality rate has gone from the best in the nation in 1982 to one of the worst in 2001.

Delaney has been on the job just a few months, but she is bringing enforcement ideas to D.C. from her previous experience in Connecticut. Starting a program of routine compliance checks such as those employed in other Fifth District states is high on her list of priorities.

The first step, Delaney says, is to educate and train the people who serve and sell alcohol in the District. In a series of seminars, Delaney plans to put the private operators on notice by saying: "Hey! We're going to be starting these [compliance checks]. This is what

On Every Corner?

Liquor stores in the Fifth District

State	Stores ^a	Population ^b	Population Per Store	Regulatory Status
District of Columbia	266	570,898	2,146	Open
Maryland	1,057*	5,458,137	5,164	Mixed ^c
North Carolina	389	8,320,146	21,389	Control
South Carolina	872	4,107,183	4,710	Open
Virginia	271	7,293,542	26,913	Control
West Virginia	155	1,801,873	11,625	Control ^d
Fifth District	1,953	27,551,779	14,107	Mixed

^aTotal number of liquor stores, including stores that sell other things, as of March 2003

^bU.S. Census Bureau estimate for July 1, 2002

^cMaryland has both open and control jurisdictions.

^dWest Virginia privatized its stores in 1991, but continues to control wholesale distribution.

*In addition to this 2001 number, some localities in Maryland allow an undetermined number of beer and wine licensees to sell liquor for off-premise consumption.

SOURCE: Alcohol regulation agencies in each state

you need to do. You need to *card* people. You can't rely on your scanning devices. You can't rely on a young kid who you pay \$2 an hour."

Stopping underage drinking will be a new priority for Delaney and her 11 investigators, but "eminent danger" investigations will continue to be critically important, she says. "If there's a shooting at a location, and the board deems that there is an eminent danger to the public ... they will do a summary suspension and actually close the place down until the next hearing date," Delaney explains. At the hearing, the board will weigh evidence and testimony and decide on whether or not to revoke the establishment's liquor license.

In the eyes of many control-state officials, Washington, D.C., is the poster child for the ills of open jurisdictions. The District has one liquor store for every 2,146 residents. In sharp contrast, Virginia has one liquor store for every 26,913 residents.

"There are a lot of stores in the District, and I think they've been very liberal with their zoning laws and their licensing laws on the size of the stores," says Griffin, the liquor control director in Montgomery County, Md. "You get a lot of pint stores and that type of thing."

The high number of liquor stores, coupled with extensive newspaper advertising, contributed to the District's consumption of 2.95 gallons of distilled spirits per capita in 2000.

That's three times the average consumption for the control states of Virginia and North Carolina, according to DISCUS numbers.

"I don't think 'consumption' is the right word," says Delaney, who notes that many commuters who work in D.C. buy liquor there and drink it at home in Virginia or in Maryland. The District also attracts many tourists who purchase alcohol but do not show up in population numbers.

All of those factors combined to produce \$44 of revenue per capita from the sale of distilled spirits in D.C. in 2000. That's more than twice the per capita revenue generated by any other state in the Fifth District, according to DISCUS. But the money comes with ominous strings attached.

"For every percent increase in average consumption, there are corresponding increases in alcoholism, sclerosis of the liver, DUI, and fetal alcohol syndrome," warns Danielsen at the Virginia ABC.

D.C.'s high revenue per capita is not the norm in other open jurisdictions. Nationally, revenue in open states averages \$13.80 per capita, compared to \$23.07 per capita in control states, according to DISCUS. In the Fifth District, Maryland's revenue is just \$7.01 per capita, and it would be even lower if it weren't for the profits generated by Montgomery County, a control jurisdiction.

Montgomery County produces far

more revenue from alcohol sales than any other locality in Maryland, but Griffin hasn't forgotten the temperance side of his control conundrum. He notes that the county also has lower per capita consumption of distilled spirits (0.80 gallons) than any other locality in Maryland. As for underage drinking, he says the compliance rate at the county-owned liquor stores is 98 percent, and the compliance rate at the licensed establishments is about 85 percent.

Griffin is proud of Montgomery County's overall performance, but he believes there is room for improvement, both in his county and across the country.

"I don't think we've ever fully arrived at a comfortable public policy approach to alcohol," he says. "At different times we've had virtually no rules, when anyone could buy whatever they wanted whenever they wanted. And then, at other times, we've gone so far as to actually have national prohibition. ... Both approaches were abject failures."

Seventy years after the repeal of Prohibition, the solution lies somewhere between, he says. "We're trying to strike that balance for the public." **RF**

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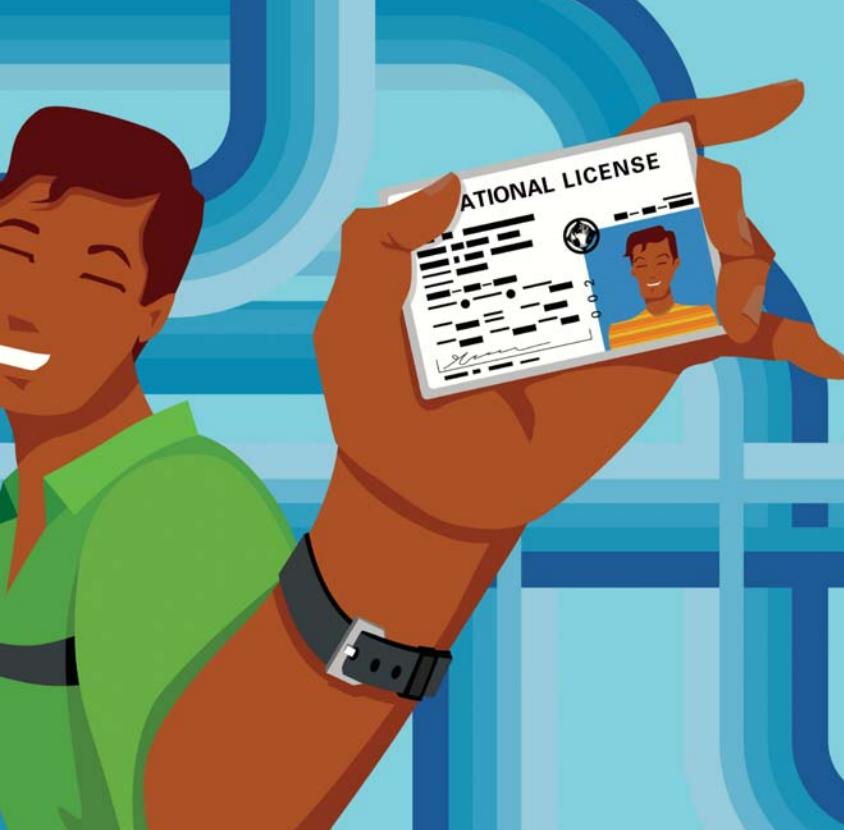
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MAY I SEE YOUR License, Please?

*Excessive Occupational Licensing Can
Cost Consumers Money Without Necessarily
Increasing Quality or Protection*

BY BETTY JOYCE NASH

Quantavius Bovain, a six-year-old student at Harbison West Elementary School in Columbia, S.C., opens his mouth wide “like an alligator” as dental hygienist Laura Hancock cleans his teeth. Hancock treats Quantavius’ teeth with fluoride and seals them to deter decay. She works for a private firm in partnership with the South Carolina Department of Health and Environmental Control’s public health dental program, resurrected in 2000 after the fiscal woes of the early 1990s cut off the service.

Quantavius’ teeth might have gone untreated were it not for a public health dental program called Healthy Smiles Partners. To widen access to dental care, South Carolina, along with some other Fifth District states, is changing current state laws that restrict the way hygienists work. Previously, hygienists could only work on premises with dentists. The change allows hygienists to work without a dentist on the same premises as long as it is in a public health setting. The question arises, if hygienists can work without direct supervision in public health settings, why can’t they do so elsewhere, and reduce the cost of dental services?

Dental care is a luxury for many low-income people, according to a 2003 report by the Center for Health Ser-

vices Research and Policy at The George Washington University Medical Center. Poor people tend to have more tooth decay and either forgo or put off dental care until it’s too late to save teeth. The report cites many reasons for this, including the state regulations: “The licensing system and self-regulation by the dental and medical professions have profound implications for low-income children.”

This is just one example of state occupational oversight that can stifle entrepreneurship and raise prices. Such practices can increase wages for practitioners at the expense of consumers, economists say. And consumers may use licensing as a signal of quality when, in fact, there’s often no evidence that such regulations are effective.

Born in Babylonia, Reared in Medieval Guilds

The regulation and licensing of occupations in the United States, practically nonexistent in 1900, has grown to include some 1,000 occupations regulated today by one or more of the 50 states.

Licensing in the 1950s affected about 3 percent of the labor force, but today licensing affects about 18 percent of all U.S. workers, more than the minimum wage or unionization, according to Morris Kleiner, a pro-

fessor of labor policy at the University of Minnesota. In Virginia alone, the state licenses well over 100 occupations, from auctioneers to wrestlers. The North Dakota legislature recently added bikini waxing to a list of cosmetic procedures allowed by law.

Occupational licensure has roots in ancient civilization (the Code of Hammurabi) and showed up later in medieval guilds, whose purpose was to create and keep a monopoly. Some guilds persisted, however, especially in the retail trade and small-scale service enterprises. “It was only with the appearance of shopping centers and ‘supermarkets’ after World War II that butchers and bakers lost their professional status, while such groups as plumbers have managed to keep that status,” writes medieval historian Lynn Harry Nelson. The regulatory movement gained momentum during the Progressive Era, aided by consumer activists and “muckraking” journalists who exposed dangerous products and conditions in the marketplace. Ultimately federal agencies overseeing certain industries, such as the Food and Drug Administration, among others, were created.

Today’s state occupational licensing rules are promulgated by boards made up of the people who stand to gain from

rules that restrict entry to professional occupations — the members of the profession. While licensing rules vary from state to state and occupation to occupation, they usually include some combination of prescribed formal education, experience, a test, good moral character, and citizenship. In some cases, the rules can even include limitations on practice ownership, as is the case with dentistry in Virginia, where only a dentist can own a dental practice.

“For the occupations, there’s a real incentive to restrict supply and increase earnings and increase the perception of quality within the occupation,” Kleiner says. “...for consumers, the benefits of fighting restrictive [regulations] is relatively small. It’s not worth the effort of going to lobby the legislature or going to the licensing board trying to loosen restrictions.”

Economists have studied occupational regulation at least since the days of Adam Smith. In *The Wealth of Nations*, published in 1776, Smith questioned whether long apprenticeships guarantee good work:

“The patrimony of a poor man lies in the strength and dexterity of his hands; and to hinder him from employing this strength and dexterity in what manner he thinks proper without injury to his neighbour, is a plain violation of this most sacred property. ... To judge whether he is fit to be employed, may surely be trusted to the discretion of the employers whose interest it so much concerns. The affected anxiety of the law-giver lest they should employ an improper person, is evidently as impertinent as it is oppressive.”

Most studies examining whether restrictions improve quality find few such benefits, according to a 1990 Federal Trade Commission (FTC) study, “The Costs and Benefits of Occupational Regulation”:

“Even in the situations in which licensing increases the quality of the licensee-provided service, consumers are not necessarily better off. Price increases due to licensing may cause some consumers to ‘do without’ the service, or to ‘do it themselves.’”

The FTC study notes the “capture theory” of occupational regulation, which holds that professionals seek to protect themselves from competition and, in doing so, increase income. Economic theory suggests rules aimed at limiting entry will cut supply and raise prices. The FTC report noted a 1982 study that found dental prices to be about 4 percent higher in metropolitan areas in states limiting the number of hygienists that dentists can employ.

An alternative to licensing, suggests Kleiner and the FTC study, is certification. For example, travel agents and car mechanics are certified, notes Kleiner. “Licensing by definition is that you need state permission to do the work. With certification, others can do the work but the public knows the individual has gone through training requirements.” Certification may also require testing and education.

Perhaps the best consumer protection is provided by reputation. Some professions use independent regulatory agencies, such as Underwriters Laboratories Inc., to advertise that their products have been tested in accordance with trusted standards.

Another protection for consumers against deceptive trade practices exists by statute already, says lawyer Steve Simpson, who works for the Institute for Justice, a nonprofit group in Washington, D.C., that investigates regulations that keep entrepreneurs out of the marketplace. The fear of litigation often enforces good practice. “The tremendous amount of liability companies face when they do things wrong is a huge incentive to do things right,” he notes. “[Professionals] are much more worried that they’re going to get

Occupational Licensing and the Internet

Licensing laws grew partly from the idea that it’s expensive and time-consuming for consumers to gather information they need before finding a service. But today, the flow of information on the Internet reduces the cost for computer-literate consumers to make informed decisions about purchases of goods and services.

And doing business in cyberspace, where no state lines exist to mark territory, raises plenty of questions about state occupational licensing.

“There have been several studies of the impact of the Internet on prices ... and licensing reduces some of the cost effectiveness of those transactions by limiting the ability of individuals to order or get services through the Internet...,” says Morris Kleiner, an economist at the University of Minnesota.

The Federal Trade Commission (FTC) last fall held a public workshop as part of an ongoing effort to examine anticompetitive barriers to Internet commerce, says Jerry Ellig, acting director of the office of policy planning for the FTC.

The FTC weighs in when Internet commerce is stifled because of anticompetitive practices, such as the case of the Internet-based casket seller who sued the state of Oklahoma over a state law requiring casket retailers to hold a funeral director’s license.

The possibilities for bumping up against

state licensing regulations are endless. For example, Ellig says some state real estate appraisal boards want companies who do automated appraisals to obtain licenses, although the FTC has not investigated that situation in depth, he says. The FTC also intervened recently in a proceeding before the Connecticut Board of Examiners for Opticians, who are considering whether Internet retailers who sell contact lenses to Connecticut customers need an optician’s license.

“We argued that a firm which only sells contact lenses and simply takes sealed boxes of lenses received from a manufacturer and puts them in an envelope and mails them to consumers...shouldn’t have to have an optician’s license,” Ellig says. Opticians are licensed because they actually make eyeglasses and that takes skills and training. “But fabricating eyeglasses is different from taking a marked box from a manufacturer and matching it to a prescription and dropping it in the mail.”

Such licensing laws can restrict the commercial benefits of the Internet, says Kleiner. “To the extent that other services..., medical devices, and pharmacy-related products have similar state occupational licensing-related restrictions, this may limit the ability of consumers to purchase products which have the lowest cost relative to quality,” he says.

—BETTY JOYCE NASH



RETTY JOYCE NASH/IRF OF RICHMOND

In South Carolina, hygienists may clean and seal the teeth of low-income children as part of a public health program.

sued by a customer than that a licensing guy is going to come by and write them a ticket.”

The Case of Dentistry

Several economic studies have examined the statutes and regulations governing dentists. Kleiner, for example, studied U.S. Air Force recruits to see how restrictive licensing laws affected outcomes of service, prices, and practitioner earnings. The study used data from the young recruits’ first dental examinations after entering the Air Force, as well as relevant socioeconomic information, including recruits’ home states and income, among other characteristics. “We tried to see, if they came from a state that had tougher licensing requirements, how was their dentitia at that point in their life?” Kleiner explains, adding that he and co-author Robert Kudrle found that restrictions did not improve dental health but did raise prices of basic dental services.

Similarly, an economic analysis by the Virginia Department of Planning and Budget found that proposed regulations by the Board of Dentistry that limit the number of dental hygienists per supervising dentist except in public health and volunteer work settings would have a negative economic effect. The 2003 analysis states: “Overall, the new proposed regulation continues a set of practice restrictions that both increase costs and reduce the quantity consumed of

dental care without providing any commensurate public health benefits.” (States differ in supervision levels, with about 13 states requiring dental hygienists to work directly under a dentist on the premises. Virginia and other Fifth District states are among the few that currently do not allow general supervision, which allows the hygienist to perform services while a dentist is not present, but has authorized treatment and will evaluate the hygienists’ performance later. However, most of those states allow hygienists to work in public health settings under general rather than direct or indirect supervision.)

The American Dental Association (ADA) opposes general supervision because it fails to protect public health, according to Dr. Laura Neumann, of the ADA. Most states do not restrict the number of hygienists a dentist can supervise, according to the ADA; however, several Fifth District states have pending legislation that would limit that number.

African Hair Braiding and Caskets

Health professions are but one of many professions under scrutiny. In 1991, the Institute for Justice challenged the District of Columbia’s cosmetology licensing regulations in *Uqdah v. Board of Cosmetology*. At the time, the District required African hair-braiding businesses to comply with extensive training requirements to procure a cosmetology license. But the 1,500 hours mandated had little to do with natural hair braiding, according to the Institute. The legal effort changed licensing laws in the District and, since that time, has contributed to changes in cosmetology licensing laws in 14 states.

“As you can imagine, this is a skill that people learn when they’re young,” Simpson says. “They learn it as kids and, rather absurdly, the states try to regulate them when they decide to go into business doing it.”

The Institute seeks cases in which the licensing laws are ridiculous, Simpson says. In 2001, the Institute challenged regulations that require casket retailers to be licensed funeral directors, a requirement in some states. That drives up

casket prices, the largest portion of a funeral’s cost. The 6th U.S. Circuit Court in Tennessee recently sided with the Institute; the issue is being challenged in Oklahoma, too. Simpson says that often lawmakers are unaware of such economically inefficient regulations.

“A lot of times we’ll bring cases and the legislators will recognize that these are absurd laws,” he says. “When you have an active and organized group like funeral directors and a disorganized public, there’s a huge incentive for a small organized group to get the law changed and no incentive for the man on the street to care about it.”

The rationale for occupational licensing has typically been to protect public health and safety. Occupational licensing can be useful when consumers, for whatever reason, lack information about or have difficulty determining professionals’ quality.

But economists continue to question what people are buying for the higher prices associated with licensing.

“Prices are higher, quality is uncertain, and you don’t know if it’s better or not,” Kleiner says. **RF**

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Seeing the Light

Communities in Catawba County, N.C., supported the growth of optical fiber and cable producers to help maintain the county's manufacturing sector.

BY CHARLES GERENA

Until the growth of the telecommunications industry slowed to a crawl, 40 percent of the world's fiber optic cables reportedly flowed from one place — Catawba County in western North Carolina. Factories in Hickory and Claremont churned out millions of kilometers of these light-carrying communications lines, as well as the optical fibers inside of them.

The initial location of cable and fiber production in Catawba was more a product of chance than design. Through a series of acquisitions and mergers, locally owned plants ended up in the hands of three major suppliers to the telecom industry — CommScope Inc., Corning Inc., and Alcatel.

But executives could have expanded their firms elsewhere when the demand for cable and fiber increased. Instead, they chose to invest in their existing facilities in Catawba. The county had several economic advantages, from its established industrial base to a labor pool that encompasses a four-county metropolitan area north of Charlotte. What ultimately made the difference, though, was the lobbying of government officials who wanted to keep industry alive in Catawba County.

The production of hosiery, furniture, and other goods has been an important part of the county's economy, thanks in part to cheap electricity from Duke Power's hydroelectric plants on the Catawba River.

"We have always been heavily manufacturing oriented," notes Scott Millar, president of the Catawba County Economic Development Corporation. There were 575 manufacturers in the county as of June 2002, the third-highest number in North Carolina.

However, Millar says most of the county's manufacturers could be classified as small businesses. "There are quite a few firms that are two-, three-, or five-person hosiery operations, or small furniture production facilities," he describes.

Employment in the hosiery and furniture sectors has been shrinking for years. Dean McGinnis, Claremont's city manager for the last 15 years, attributes this trend to the same factors that have hurt many labor-intensive industries —

automation and increased competition from less expensive imports. "We have not lost a furniture factory," he notes. "They have just fallen down in the hierarchy" of employers.

So McGinnis and other officials throughout Catawba County have been hunting for other manufacturing sectors that need workers. In particular, they have coveted producers of telecommunications equipment, plastics, and other high-tech goods. These firms are thought to pay higher wages than producers of textiles and other "low-tech" goods. They also are supposedly less likely to relocate abroad to reduce their labor costs. (See sidebar.)

Fiber optic cable and optical fiber production fit the bill for industry-hungry Catawba County. The region had a foot in the door with Superior Cable Corporation, which was founded in Hickory in 1953 and opened a plant in Sherrills Ford in 1966. These facilities would later be sold to new owners, providing the foundation for CommScope and Corning's fiber optic cable production in the county. Also, CommScope's Chairman and CEO Frank Drendel developed strong relationships within the cable television industry.

As the expansion of long-distance telecom markets spurred demand for fiber optic cable and optical fiber in the 1980s and '90s, local officials lobbied cable and fiber companies.

For example, when Alcatel wanted to expand its optical fiber production in the early 1990s, McGinnis says that Claremont got the new factory in 1992 because local officials "offered innovative ideas and incentives." The county bought the land for the factory and sold it to Alcatel, which paid for the purchase out of future tax payments. The city built a sewage treatment plant to accommodate the factory's waste flow.

Then came the rapid expansion of telecom networks during the latter half of the 1990s. Backlogged cable and fiber producers struggled to keep up with demand. Sensing the opportunity at hand, Catawba County and local governments stepped up their efforts to encourage producers "to make their investments here rather than somewhere else," recalls Millar. Grants, work force

The Allure of High-Tech Manufacturing

When recruiting industry, economic development officials often favor producers of high-tech goods. For officials in Catawba and other counties in the Hickory metropolitan area, the focus has been on fiber optic cable and optical fiber manufacturers. Are such firms better for a community's economy than producers of low-tech goods?

One reason that officials give for targeting high-tech manufacturers is that workers earn relatively higher salaries. A June 1999 analysis by the Bureau of Labor Statistics (BLS) showed that at least 10 high-tech industries—from communications equipment to aerospace—paid at least 50 percent more than the median wage for all industries.

A March 2002 BLS report explained why high-tech manufacturers could pay more: they have achieved higher annual growth in labor productivity compared to the industrial sector as a whole. "The benefits for workers from growth in labor productivity are reflected in rising real wages and other compensation," wrote economists Christopher Kask and Edward Sieber in the report. "Over time, trends in real labor compensation tend to parallel trends in labor productivity."

Economic development officials also target high-tech manufacturers because they appear to be less likely to relocate in search of cheaper labor. This is a problem that has plagued communities where furniture and textile factories once played a large economic role.

But the likelihood of a plant relocating doesn't depend on whether the manufacturer is high-tech or low-tech, argues economist Joseph Cortright of Impresa, a Portland, Ore.-based consulting firm. "The issue is whether the plant is doing routine, mass production or something that

it is good at doing in a community."

Cortright says a new product usually requires continued refinement and customization during the production process. Therefore, the manufacturer needs engineers behind the scenes and highly skilled workers on the factory floor. As long as it finds this valuable human capital and other unique resources in a community, it will continue to operate its plant there. As the production process becomes more standardized, however, the product can be made by less specialized, low-wage workers that can be found anywhere in the globe.

Based on this analysis, one could surmise that high-technology manufacturers are less likely to bolt from a community than other producers because their products are more sophisticated. But that's not always the case. For example, the manufacture of compact discs used to be more complicated, says Cortright. "Now, it is a very routine process," so the cost of labor became a more important consideration than the quality of labor. As a result, Sony Disc Manufacturing shut down its plant in Oregon and transferred production to other facilities.

In Catawba County, fiber and cable production is still an exacting process. Equipment must be precisely controlled to produce glass fibers that have few impurities, that are the correct diameter, and that have specific physical and optical properties.

Also, Alcatel and CommScope Inc. operate research and development centers near their plants. "That is a very important indication," notes Cortright. "It signals that [they are] doing higher value-added functions in the community, and those jobs are more likely to stick around."

—CHARLES GERENA

training, and other incentives "were developed to facilitate their growth."

Driving through the county's small communities, it's easy to see the growth of the "big three" cable and fiber producers. CommScope, a fiber optic and coaxial cable manufacturer headquartered in Hickory, operates industrial and research facilities in Claremont and Newton that occupy over 1 million square feet. Corning runs its Cable Systems division in Hickory, as well as two cable plants that total more than 800,000 square feet. Alcatel has corporate offices in Hickory, produces cable and fiber at a million-square-foot complex in

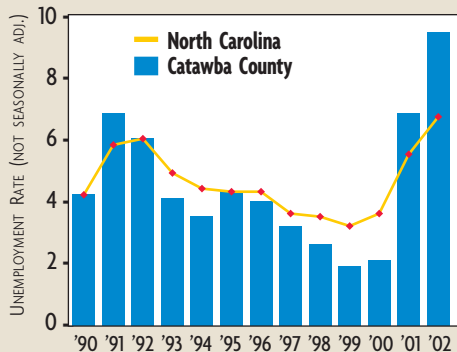
Claremont, and operates a research and development center in the latter city.

Even so, the local economic effects of large manufacturers can be disappointing in "small communities that lack the ability to fully absorb those impacts," wrote Dennis Roth in a January 2000 article for the Economic Research Service of the U.S. Department of Agriculture. "Branch plants in rural communities may not benefit the poor and unemployed because they bring employees with them, hire more skilled immigrants, or stimulate long commuting from other communities."

Indeed, the employment and payroll effects of Claremont's two fiber optic

Fiber Insulation

For a while, the expansion of optical fiber and cable production in Catawba County helped compensate for labor reductions at textile makers and other manufacturers. But the downturn in fiber and cable made the county fare worse than the state in 2001 and 2002.



SOURCE: Employment Security Commission of North Carolina

cable plants are widely dispersed. The city has only 1,000 residents, so the facilities draw laborers from throughout Catawba County and the broader Hickory metropolitan area, which also includes the counties of Alexander, Burke, and Caldwell.

Factory workers spend some of their salaries at commercial establishments in town. McGinnis says this has helped stimulate commercial development. Still, most of their pay goes back home at the end of the workday.

The money spent by the manufacturing plants themselves also leaks out of rural areas, argues Roth. "Because a branch plant has many economic linkages outside the local community, its activities create a much smaller multiplier effect than its urban counterparts."

For example, several suppliers of equipment and components have located sales and service offices in Catawba County, including a Canadian maker of fiber production systems named Tensor. But not many of them operate factories nearby. "They have mostly showrooms and small R&D facilities" in Catawba, says Ken Luterbach, sales and technical manager at Tensor's office in Hickory. Most of their production is done elsewhere in the United States, Canada, and Europe.

Nevertheless, Catawba's cable and fiber plants contribute substantially to

the local tax base. Revenue from utility surcharges, property taxes, and other levies paid by plants helped small cities like Claremont expand municipal services like fire and police protection. While some of this added capacity was needed to keep plant managers happy, residents also reaped the benefits.

Now that the telecommunications industry is retreating, however, the economic punch of Catawba's cable and fiber plants is growing weaker.

Capacity far exceeds the demand, especially on long haul networks. Less than 30 percent of all long haul fiber was activated by 2001, according to a report by the Telecommunications Industry Association.

This has led to fewer communications lines going into the ground and, subsequently, less demand for fiber optic cable and optical fiber. Worldwide fiber production fell an estimated 50 percent in 2002, with the steepest drops in North America and western Europe. In a recent report for KMI Research, Patrick Fay noted that the fiber market has shifted to Asian countries like China where networks are in earlier stages of development.

Not surprisingly, cable and fiber producers have scaled back their production. Corning and CommScope have laid off hundreds of their plant workers and engineers in Catawba County. Alcatel has scaled back its R&D activities in Claremont and mothballed its fiber plant, but continues to produce cable from an adjoining facility.

This retrenchment has added to the job losses in Catawba County's manufacturing sectors. Not adjusted for seasonal changes, the county's jobless rate shot up from 3.5 percent in January 2001 to 9.1 percent in January 2003. "At one point last year, we were recognized for having the highest percentage rate change [in unemployment] over the previous 12 months in the nation," says Millar. "It has been a difficult pill to swallow, from feeling invulnerable to having to look at a lot of other opportunities."

Telecommunications analysts and executives say it will take a while to absorb the industry's excess capacity. But fiber optic cable and optical fiber

producers remain cautiously optimistic. A core demand still exists for their products, driven by the need to improve the quality of networks. Glass fibers transmit data with fewer errors than copper wires, thus reducing the need to re-send data and increasing network performance.

While many long haul networks are fiber based, Corning executives and others believe that the telecom industry is still in the early stages of replacing copper with fiber. Operators of short haul networks, which transmit data between local loops in communities, are still making the transition. And, many of the local loops that connect homes and businesses to central switching stations haven't been upgraded. But in order for telecom carriers to broadly embrace optical fiber, there must be greater demand for the high-bandwidth services that require the capacity and quality of fiber.

Despite these challenges, local officials don't regret fostering cable and fiber production in Catawba County.

"We have not written off the telecom industry," says Millar. "Cable and fiber producers have invested in their work forces and facilities here, and I feel that they will invest here again as they achieve their growth plans in the future." Meanwhile, the county will keep searching for new industry. **RF**

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No Silver Bullet

BY BETTY JOYCE NASH

*Tax and Spending Limits,
Though Often Useful, Can't
Cure All Budgetary Ills*

Think you can balance your state's checkbook better than your state legislators can? In 24 states — none in the Fifth District — citizens can collect signatures and pass tax-and-spend limits (or other laws) via the ballot box. Alas, the limits have not immunized participating states from current financial illness.

For instance, in 1994 Colorado instituted spending limits by constitutional amendment, the Taxpayer Bill of Rights or TABOR. The amendment stipulates that tax increases be approved by voters. It also limits growth in state spending and limits tax increases to inflation plus the population growth and says excess revenue must be refunded. But Colorado is in the midst of its worst fiscal crisis in more than 50 years.

Nationwide, states are still in the hole by about \$21.5 billion in the current fiscal year, 2003, according to the National Conference of State Legislatures. And in 2004, 41 states expect a cumulative gap of more than \$78.4 billion.

"What really happened is the revenue disappeared," says Nicholas Jenny, senior policy analyst with the Nelson A. Rockefeller Institute of Government's Fiscal Studies Program. The National Association of State Budget Officers' Stacey Mazer observes that Wyoming, a state operating with tax-and-spend limits driven by voter initiative, is weathering the crisis nicely but for different reasons.

"Their sources of revenue aren't personal income but resources," she says, referring to the state's coal, oil, and gas production. "They're one of the few states without a budget problem [but] I would not attribute it to the [tax-and-spend limit] initiatives." States whose budgets depend on personal income taxes have fared the worst, she says.

Historically, most of the states with constitutional authority to use voter initiatives are west of the Mississippi River. The first such effort took place in South Dakota in 1898 at the dawn of the Progressive Era. Eighteen states followed in the next 30 years and six more followed in the last half of the 20th century. The concept didn't catch on in the East probably because Easterners were afraid that newly arrived immigrant populations would upset the status quo. Today, the Eastern states that permit voter initiatives are Florida, Maine, Massachusetts, and Mississippi.

"The populist movement was strong in the West, where many people believed that corporations and business interests controlled state governments," says Alan Tarr, of the Center for State Constitutional Studies at Rutgers University. Also, Western states were just putting their constitutions in place at the turn of the last century. "[That] gave an opportunity to make direct democracy part of the original constitutional design."

Research by John Matsusaka, an economist at the University of Southern California, shows that state spending was about 4 percent per capita lower in states with voter initiatives than in pure representative states. Matsusaka used 30 years of data to compare fiscal behavior in states that permit voter initiatives and states that allow only legislators to pass laws. While spending in voter initiative states was lower, local spending was higher. "After one controls for income, population density, metropolitan population, population growth, mineral production, ideology of U.S. senators, and federal aid, initiative states have lower combined state and local direct general

expenditure, spend more locally and less at the state level, and rely less on taxes and more on charges to generate revenue than pure representative states," explains Matsusaka.

"The initiative process in theory and practice can have an effect on fiscal policy independent of there being a TEL [Tax and Expenditure Limitation]," he says. "Simply the fact that it's out there and it's a threat has an effect on the way the legislature behaves."

Barry Poulson, an economics professor at the University of Colorado, attributes that state's current fiscal crisis partly to changes in the tax system, namely a flat tax enacted in the late 1980s that increased income taxes as a source of revenue. And that's made revenues more volatile, according to Poulson. Colorado's constitution includes tax-and-spend limits but also includes an amendment that mandates spending for public education.

"It is fair to say that no one predicted how these constitutional constraints would impact state fiscal policy in the current recession, nor is it clear how to unravel this constitutional puzzle," Poulson notes. Poulson advocates a budget stabilization fund linked to a revenue limit. In good times, surplus revenue could go to a rainy day account and a portion to tax refunds and cuts. He further suggests that constitutional constraints on taxes and spending could be nonbinding in recession years and become binding again in good times.

Colorado's experience could be instructive to Fifth District states considering solutions to fiscal problems. Properly constructed, there seems to be some evidence that tax-and-spend limits may check government growth. But they are not a panacea. **RF**

Kenneth Rogoff

The International Monetary Fund (IMF) was founded in 1945, along with its sister institution, the World Bank, in an effort to stabilize the international economic order. In recent years, the IMF has come under intense scrutiny from a wide range of sources. It has been the target of anti-globalization activists, who have taken to the streets to protest the organization's policies, and of the Nobel Prize winning economist Joseph Stiglitz, who has taken the IMF to task on a panoply of issues in his book *Globalization and Its Discontents*.

In August 2001, Kenneth Rogoff took a two-year leave of absence from Harvard University to become the chief economist at the IMF. (He will rejoin the Harvard faculty in the fall of 2003.) During his academic career and earlier stints with the IMF and the Federal Reserve's Board of Governors, Rogoff established himself as an expert on international finance, debt, and monetary issues. His 1985 article for the *Quarterly Journal of Economics*, "The Optimal Degree of Commitment to an Intermediate Monetary Target," spawned a vast literature on central bank design. And his textbook, *Foundations of International Macroeconomics*, co-authored with Maurice Obstfeld, is widely used in graduate classes.

Rogoff is also an expert chess player, obtaining the lifetime title of International Grandmaster (the highest rank awarded by the World Chess Federation) in 1978. He retired from tournament competition at the age of 25 to focus on his economic research. Aaron Steelman interviewed Rogoff at the IMF's headquarters in Washington, D.C., on April 15, 2003.

RF: How does the IMF's role differ from the World Bank's?

Rogoff: The two organizations are quite similar in some ways. They are both, broadly speaking, United Nations (U.N.) family institutions. But they have different voting structures than the U.N. Votes in the IMF and the World Bank are loosely weighted by size of economic contribution to the global economy, so that the European countries, Japan, and the United States have a disproportionately large vote. The IMF and the World Bank also have interlocking boards of directors, so some people sit on both boards.

As for how they differ, the IMF is charged with trying to promote global financial stability and growth, while the World Bank directs its efforts at alleviating poverty. The IMF provides support to the World Bank in working toward that goal, but that is not our primary mission. Importantly, the IMF is only allowed to lend to sovereigns, whereas the World Bank does not face any such restriction. It is also worth noting that the World Bank is also much larger in terms of staff and budget than the IMF.

So what does it mean, in practice, to "promote global financial stability"? Part of what we do is constantly loan paid-in capital to emerging markets and developing countries. For instance, in the 1990s we made some large loans to South Korea, Thailand, and Indonesia, and more recently we have loaned to Argentina, Brazil, and Turkey. But there are also many smaller loans out there. It's not unusual for us to have so-called "programs" going in 30 or 40 countries at one time. The important issue we look at in assessing the size and structure of a program is whether an individual country's problems might pose systemic risks to the global financial system.

Such lending is the headline activity of the IMF, but there is also another big element to what the IMF does. We provide a forum for countries to meet and provide information—both formally and informally—to one another. This allows policymakers to exchange ideas about best practices during noncrisis periods. In fact, many of our staff papers deal not with crisis issues but instead with more general macroeconomic issues. Finally, of course, every member country must submit themselves to bilateral review of their economic policies every year or two.

RF: When you came to the IMF, were there certain economic issues that you thought should be the focus of your department's research?

Rogoff: I think it's very important, when coming to a job like this, to have an open mind and to realize that some of the best ideas come from the bottom up. You have to really listen to people and to give people room to be creative. But, yes, there are some specific issues that I wanted us to work on, such as exchange rates for developing countries. Before I came to the IMF, I had done a lot of work on industrialized countries but I had never really worked on low-income countries, and it quickly became apparent that they have many interesting special problems. For instance, the amounts of international aid going to poor countries are very large as a percentage of their overall budgets—we're sometimes talking 10 or 20 percent. How do you manage this macroeconomically? Also, consider Africa. Many of those countries are subject to huge commodity price shocks. How do you conduct monetary policy when your main export—which produces, say, 80 percent of your country's income—can vary up or down by more than 40 percent? These are very interesting questions that just never would have occurred to me if I hadn't come here.

We are also interested, of course, in the international financial architecture and all that entails: capital controls, the international bankruptcy court, and other issues. And I'm very interested in new open-economy macroeconomics, an interest that grows out of my work with Maury Obstfeld. When I came here, the Fund had a model that was, I think, very effective at looking at what occurs if there is an oil or global productivity shock. But the model was 20 or 25 years old, so I wanted to replace it with a newer model, and we have made a lot of progress in that direction. I must say, though, that much of what we have been able to accomplish is because other places—such as the European Central Bank and the Federal Reserve Bank of New York—have been refining their own models. Not surprisingly, I would say that most of the work we do has more of an

So what does it mean, in practice, to “promote global financial stability”? Part of what we do is constantly loan paid-in capital to emerging markets and developing countries.

empirical, policy bent than you would see at a university seminar series.

RF: The IMF has been attacked from all sides: from the left for pushing “neo-liberal” policies in developing countries, and from the right for creating moral hazard problems as a result of its lending. How would you respond to such critics?

Rogoff: The most important thing for us to do, and it's the honest truth, is not to respond to the critics but to listen to them. Indeed, broadly speaking, the IMF and the World Bank are quite receptive to criticism and have made some serious changes over time. In 1980, for instance, the World Bank was not in favor of free trade. Similarly, the IMF was much more Keynesian 25 years ago than it is today. It's not easy for these institutions to move quickly—you need to achieve consensus among a large number of board members, some of which represent a large number of countries—but the critics have made a difference.

The second thing that I want to say is that almost everyone in academia has some criticisms of the World Bank and the IMF. I sure did. I



SCOTT SUCHMAN

wrote some of the first papers on moral hazard and IMF lending in the late 1980s with Jeremy Bulow. We took a fairly cynical view of the whole process. I also wrote a paper with Maury Obstfeld called “The Mirage of Fixed Exchange Rates” that said it was a disaster to support fixed exchange rates, which was conventional wisdom at the time. This view, which has now by and large become the conventional one, is an example of why one has to resist always trying to come down somewhere in the middle on debates, which is a natural tendency in an institution like this.

RF: It’s pretty surprising that 25 years ago free trade would have been a controversial idea at the World Bank or IMF, since liberal trade policies were so widely accepted by the profession as a whole.

Rogoff: You have to understand that the institutions are governed by their member states. A lot of countries will say that if you look at the history of the industrialized world, many countries have had protectionist policies. Even today, the United

States and the European Union remain quite protectionist in some areas, albeit far less than most developing countries. I think that is very unfortunate. It strengthens the hand of protectionists in developing countries who say, “Look—today’s rich countries got that way by using protectionist policies. Why are you so sure that we should reduce our trade barriers? Shouldn’t we protect our infant industries?” So, the free trade position, which economists will say is obviously correct, will not be so obvious to some of the people from our member states. This is a good example where the middle ground was not right. Free trade was, in many ways, the radical position 25 years ago, even though it was right. And I think that some of the people who still remain skeptical of liberal trade policies are coming to the realization that globalization is something that you can’t really stop.

RF: Your open letter to Joe Stiglitz drew a lot of attention from economists, but may not be as familiar to others. Could you briefly describe what you had to say in response to the criticisms he has made of the IMF?

In the 1990s, certainly, I think countries looked at the financial liberalization of the United States and asked how they could follow that type of framework.

Rogoff: I think that it’s a very passionate and angry book, which is part of its effectiveness. It is directed at a broad audience and it clearly hits a chord with many people. Certainly if you asked professional economists if they agreed with some of the arguments in the book, they would say yes. It covers a laundry list of problems with the IMF, from the left, from the center, from the right, from outer space. And as Jagdish Bhagwati said in his review, if you launch enough missiles, you’re bound to hit some targets. In that regard, I would highlight the issue of premature financial liberalization being something that one wants to be very wary about. I certainly agree with Joe on that, though I also think that if Asian countries had genuinely flexible exchange rates in the 1990s, we might have only seen a mini-Asian crisis instead of a full-blown one. And Stiglitz’s book agrees with the general proposition of having an international bankruptcy court, an idea the IMF has advanced over the past couple of years.

But there are some areas where I think he takes very odd positions. For example, let’s say you have a country in a severe debt crisis that has been cut off by its lenders. Should the IMF criticize the country for not engaging in countercyclical fiscal policy? Or if a country’s exchange rate is under attack, I don’t think it should respond to it by printing more money.

In general, I have trouble summarizing my take on the book, because it draws in everything anyone has ever written. But, at the end of the day, when you set aside the personal attacks on the competence, intelligence, and moral character of the IMF staff, there are clearly some well-taken points in the book.

RF: The IMF gets a lot of attention for its efforts to help prevent and deal with crises. But there are some very important issues that can’t be characterized as crises, but which still probably lower the standards of living of millions of people — such as Europe’s rigid labor market policies. What sort of counsel can you provide to member countries on these types of issues?

Rogoff: We have an analytical piece on that very topic in the April 2003 issue of *World Economic Outlook*. We ask what are the costs to Europe because of its labor market institutions — and what would be the gains if those institutions were brought to U.S. levels? We use two different models to look at those issues. We come up with estimates that Euro-area unemployment would fall about 3 percent and output would be 10 percent higher if those institutions were brought to U.S. levels. That doesn’t prove that they should make these changes,

because there are transition costs and allocative issues, not to mention some noneconomic concerns that might affect Europe's decisions.

We can present our analysis and try to create a dialogue, but it's really hard to do much more than that. We don't have much traction with developed countries on these types of issues. It's also important to note that countries do look at each other and notice when certain countries are growing and they ask what it is that they are doing correctly. That doesn't mean that they will change their policies overnight. But it can have an effect. In the 1990s, certainly, I think countries looked at the financial liberalization of the United States and asked how they could follow that type of framework. And they were much more affected by this than by anything that the IMF might have told them about the issue.

RF: What do you think are the prospects for economic liberalization in the Middle East?

Rogoff: Growth in the Middle East has been very, very poor. Per capita GDP over the past 20 years in the Middle East region as a whole has fallen by 1.6 percent a year. It has been the worst performing region in the world — and this includes the oil countries. There's another chapter in the *World Economic Outlook* that looks at how much higher growth could be in the Middle East if institutions — here we are talking about corruption, political rights, and other related issues — were brought into line with the world average, forget about the industrialized average. It concludes that the Middle East could see gigantic income changes.

The Middle Eastern countries have very large public sectors with very large budget deficits. They have very shallow banking systems. And they have very serious issues with corruption. These are fundamental problems that need to be addressed.

There is a role for regulation and for government intervention in certain areas, but most countries don't have the balance right. They have too much state involvement and state control. The Middle East is a region where this is particularly problematic. That said, we believe that such governance issues have to be decided by the people of these countries themselves. All we can really do is provide technical analysis and demonstrate that their economies are performing very poorly.

RF: In the 1980s, Japan was the envy of the rest of the world. What has happened to its economy?

Rogoff: Japan has a lot of banks that are not fully functional, because they have a great deal

invested in real estate and equities. And, as we know from Ben Bernanke's work on the 1930s, when the banking system goes awry, it's very hard to get it back into shape. Many corporations are being supported by banks which are themselves insolvent. Banks are keeping these corporations afloat when, in fact, they should be folded. Also, Japan's weak social safety net doesn't give them the ability to absorb changes as well as the United States can. Eventually, they will need very deep restructuring of their banking system. It's going to be painful, but until they do that, they will not have growth.

Another big problem is deflation, which is aggravating the problems that the banks have. I think the Bank of Japan should end deflation, and I think that it would be very straightforward to do it — they need to be more aggressive with their monetary policy. Even if they ended deflation, I recognize that they would still have many problems. But it still would be a big step forward.

Japan also has dire fiscal problems, in part because they have run deficits in an effort to try to jumpstart the economy. And, moreover, they have an even more urgent aging problem than does the United States; Japan's labor force is already falling.

RF: Are there certain skills that you acquired playing chess that have helped you as an economist?

Rogoff: It's hard to say. When I was an academic I did a number of papers that involved game theory. I find that game theory comes very naturally to me, whereas algebra is something I can do, but I wouldn't describe myself as very facile with it. So I definitely think there is some connection between my chess career and my ability with game theory. Also, it's certainly true that, in my current position working on policy issues, I find myself drawing on chess analogies. That's because, in chess, there is seldom a "right" answer. You very much need to consider what the other person is thinking. You're not just objectively looking at the board — you are trying to understand the other person. And in a policy environment, when you're discussing a problem or negotiating a program, you are doing much the same thing.

Kenneth Rogoff

► **Present Position**

Economic Counsellor and Director of the Research Department, International Monetary Fund

► **Previous Positions**

Faculty appointments at Harvard University and Princeton University; Economist, International Monetary Fund; Economist, Board of Governors of the Federal Reserve System

► **Education**

B.A., Yale University (1975); Ph.D., Massachusetts Institute of Technology (1980)

► **Selected Publications**

Co-author, *Foundations of International Macroeconomics* (Cambridge, Mass.: MIT Press, 1996); author or co-author of numerous scholarly articles in such publications as the *American Economic Review*, *Journal of Political Economy*, *Quarterly Journal of Economics*, *Journal of Monetary Economics*, and *Journal of International Economics*



SCOTT SICHMAN

RF

Roads to Riches

How Stock Car Racing Became a Huge Sport — and Business

BY AARON STEELMAN

Baseball is America's national pastime. But stock car racing is its fastest-growing sport, with 10 million fans attending live races across the country each year, and another 250 million watching them on television. It wasn't that long ago, however, that stock car racing was a relatively small sport centered in the Southeast.

According to oral histories of the sport, the first stock car race took place in a cow pasture in Stockbridge, Ga., in the mid-1930s. Several moonshiners were debating who had the fastest car and who was the best driver. They decided to settle it by racing around a quarter-mile dirt track in the middle of a farmer's field.

more power for their frequent getaways from the police on the windy back roads of the South.

It wasn't long before farmers realized that there was money to be made from charging admission to stock car races. They fenced off their pastures and put up gates. "The drivers' payout continued to climb, too, and eventually the cash prize at the checkered flag was worth as much as running moonshine from Wilkes County [N.C.] to Charlotte," writes Robert Hagstrom in *The NASCAR Way: The Business That Drives the Sport*.

Probably the most famous bootlegger to ever race stock cars was Robert "Junior" Johnson. He ran whiskey for his father, Glenn Johnson, who had a successful moonshine operation in western North Carolina. Johnson would go on to win 50 races on the Winston Cup series sponsored by the National Association for Stock Car Auto Racing (NASCAR).

NASCAR's Roots

Moonshiners from Appalachia were the early stars of stock car racing. But the sport may have remained stuck on the dirt tracks of the rural South if it hadn't been for Bill France, known to most as "Big Bill." France was an auto mechanic and part-time stock car driver in Maryland who, in the mid-1930s, moved to Daytona Beach, Fla. Daytona was already well known to racing fans. Its long, hard-packed beaches made it a good location for drivers to try to set new land speed records. Each year, racers from around the world flocked to Daytona to try to post faster speeds — and hopefully to break the 300 miles-per-hour mark, long seen as the



INTERNATIONAL MOTORSPORTS HALL OF FAME

Early NASCAR races were held at small tracks throughout the Southeast prior to the construction of the super speedways at Daytona Beach, Fla., and Talladega, Ala.

That first race drew a modest crowd, but word quickly spread. Soon hundreds of people began to attend similar races featuring the best drivers in the area, many of them moonshiners. Producing and distributing moonshine was illegal, of course. Those who delivered it from the stills to the customers were wary of being caught by the police — or "revenueurs," as moonshiners called them. So these drivers souped up their cars to gain a little

holy grail of the sport. But strong winds prevented drivers from hitting this mark, and by 1936, many drivers had decided to take their cars to the Bonneville Salt Flats of Utah instead.

France, who had set up a service station shortly after arriving in Florida, realized that there was a void to be filled. Many people still wanted to see racing in Daytona, and the local business depended on the tourists coming to town each year. So he organized and promoted beach races in Daytona in the late 1930s. Those races were successful and France started setting his sights higher. He wanted to establish a racing series, with events throughout the Southeast. The problem was money. He needed a sponsoring organization to get things off the ground, so he helped form the National Championship Stock Car Circuit (NCSCC) and later the unfortunately named Stock Car Auto Racing Society (SCARS). Both organizations were short-lived. But they gave birth to NASCAR in late 1947.

The organizers of NASCAR realized that their sport was plagued by some shady businesspeople. For instance, racetrack owners would often overstate the sizes of the purses or not pay them at all. This left the sport in a precarious position. If stock car racing was going to succeed, drivers would

need to be assured that they weren't laying their lives on the line for nothing. So NASCAR decided to guarantee the purses at all events it sponsored. This meant that racetrack owners would have to put down a deposit with NASCAR before the race would be held. Also, in order to assure sustained interest in the sport over the course of the year, NASCAR established a points system. Drivers would accumulate points at each race, depending on how they fared, and at the end of the year, a national champion would be crowned.

In its first year, NASCAR sanctioned three different divisions, depending on the make and models of the cars: Strictly Stock, Modified Stock, and Roadsters. Strictly Stock cars had to be full-size American cars with standard hoods, fenders, bumpers, and grilles. In other words, they would be the types of cars that average people drove on a daily basis — except they would be equipped with fantastically powerful engines. Today, NASCAR sponsors a dozen series, including several regional stock car series and the Craftsman Truck Series. But the two most popular, by far, are the Winston Cup Series, where you will find the best-known racers competing, and the Busch Series, which features up-and-coming drivers. The Busch Series is to



INTERNATIONAL MOTORSPORTS HALL OF FAME

"Big Bill" France was the guiding force behind the creation of NASCAR.

the Winston Cup what Triple-A baseball is to the major leagues. Typically, a Busch Series race will be run on a Saturday and a Winston Cup race the following Sunday.

The Super Speedways

Even after NASCAR was founded, many of the races were still run on dirt tracks. Those tracks, to be sure, were in better shape than the cow pasture in Stockbridge, Ga., where stock car racing began. But they were a long way from what we think of as modern, professional raceways. In 1949, Harold Brasington went to Indianapolis to watch the Indianapolis 500. He wondered why

NASCAR 2003 Winston Cup Series

Feb. 8*Bud Shootout (FL)[†]
 Feb. 13Gatorade 125's (FL)[†]
 Feb. 16DAYTONA 500 (FL)
 Feb. 23North Carolina Speedway (NC)
 Mar. 2Las Vegas Motor Speedway (NV)
 Mar. 9Atlanta Motor Speedway (GA)
 Mar. 16Darlington Raceway (SC)
 Mar. 23Bristol Motor Speedway (TN)
 Mar. 30Texas Motor Speedway (TX)
 April 6Talladega Superspeedway (AL)
 April 13Martinsville Speedway (VA)
 April 27California Speedway (CA)
 May 3*Richmond Int'l Raceway (VA)
 May 17*The Winston (NC)[†]
 May 25*Lowe's Motor Speedway (NC)

June 1Dover Int'l Speedway (DE)
 June 8Pocono Raceway (NY)
 June 15Michigan Int'l Speedway (MI)
 June 22Infineon Raceway (CA)
 July 5*Daytona Int'l Speedway (FL)
 July 13Chicagoland Speedway (IL)
 July 20New Hampshire Int'l Speedway (NH)
 July 27Pocono Raceway (NY)
 Aug. 3Indianapolis Motor Speedway (IN)
 Aug. 10Watkins Glen International (NY)
 Aug. 17Michigan Int'l Speedway (MI)
 Aug. 23*Bristol Motor Speedway (TN)
 Aug. 31Darlington Raceway (SC)
 Sept. 6*Richmond Int'l Raceway (VA)
 Sept. 14New Hampshire Int'l Speedway (NH)

Sept. 21Dover Int'l Speedway (DE)
 Sept. 28Talladega Superspeedway (AL)
 Oct. 5Kansas Speedway (KS)
 Oct. 11*Lowe's Motor Speedway (NC)
 Oct. 19Martinsville Speedway (VA)
 Oct. 26Atlanta Motor Speedway (GA)
 Nov. 2Phoenix Int'l Raceway (AZ)
 Nov. 9North Carolina Speedway (NC)
 Nov. 16Homestead-Miami Speedway (FL)

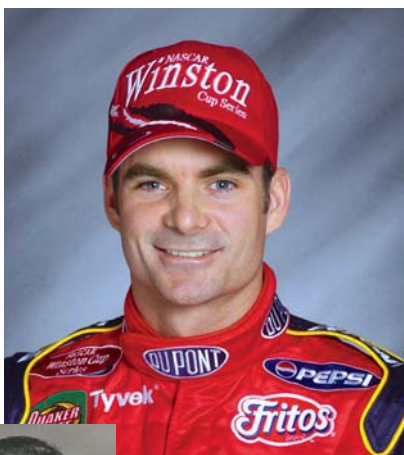
*Night race

[†]Nonchampionship point events

Schedule is tentative and subject to change; visit www.nascar.com for updates.

SOURCE: Richmond International Raceway

a 500-mile race was possible for open-wheel cars, but not for stock cars, and could think of no compelling reason. So he decided to build a paved, 1.25 mile oval track with grandstands that would seat 9,000. The location would be his hometown of Darlington, S.C. This seemed improbable for two reasons. First, a paved — and, at that time, long — track seemed unnecessarily extravagant. Second, Darlington was a tiny town. But with the help of investors and Big Bill France, Brasington completed construction of the track in the summer of 1950. That Labor Day, the first Southern 500 was run.



Robert "Junior" Johnson (left) ran moonshine in North Carolina before becoming one of the early stars of NASCAR. California native Jeff Gordon (above) has won the Winston Cup championship four times since 1995.



Few people really thought that 9,000 people would show up for the inaugural race at Darlington. If half that many came, Brasington thought it would be a success. But the event proved more popular than anyone had imagined. On race day, roughly 25,000 people came to Darlington. Since the grandstands could hold only about a third of the crowd, the organizers started selling seats on the infield area. It was, in many ways, a logistical mess for Brasington. But one that he was certainly willing to handle. It also showed France the potential of stock

car racing. He started to think of ways to tap into the sport's growing popularity. One idea: the super speedway.

To turn this idea into reality, France returned home to Daytona. He secured financing for a 2.5 mile track. This was the same lap distance as drivers ran at the Indianapolis 500, an event that France hoped his Daytona race would eventually rival. "The shape of the Daytona course, though, differed from Indy or anyplace else. It was a tri-oval, conceived by France to allow for an unobstructed view of the track from the grandstands," writes Joe Menzer in *The Wildest Ride: A History of NASCAR*. "The track was banked at a stunning thirty-one degrees in its top big turns, and at eighteen degrees in the apex of the swift dogleg that would run past the grandstands. Asked why the degree of the bank was set at thirty-one degrees, France replied simply, 'Because they couldn't lay the asphalt any steeper.' There was no place else like it in the entire world of racing."

The track struck awe in the drivers. Here finally was a track where they could see what their cars could do. NASCAR drivers had not been able to break the 140 miles-per-hour mark. But at the initial Daytona 500, run on Feb. 22, 1959, the average speed of the winner, Lee Petty, was over 135 miles per hour.

The track also struck fear in the drivers. In fact, as Petty would later remark about the first Daytona 500, "There wasn't a man there who wasn't scared to death of it." Petty himself would be involved in a horrible accident at Daytona just a few years later. His car flew 150 feet into the air, soared over the guardrail, and landed in the parking lot. He suffered a crushed chest cavity, a broken collarbone, and a broken leg. Petty, the winner of 54 races from 1949 to 1960, more than any other driver during that period, would race only six more times before retiring. His son, Richard, though, would become perhaps the best and most famous of all NASCAR drivers.

Daytona was great for spectators. With a parking lot that could hold 35,000 cars, grandstands that could seat

18,800, portable bleachers that could accommodate 6,500 more, and an enormous infield that could house 75,000 fans, Daytona was not just a race, it was an event.

Ten years after building the track at Daytona, France would construct what, in some ways, was an even more impressive course at Talladega, Ala. At 2.66 miles long and a lane wider than Daytona, Talladega became the fastest speedway, with drivers eventually posting speeds over 200 miles per hour.

Still, the Daytona 500 remained the signature event on the NASCAR circuit. When network television finally broadcast its first stock car race in 1979, it was from Daytona. To many, this may have seemed only a trifling advance for the sport. But it was much more. Cable television, which in 1979 was only in its infancy, would bring stock car racing into the homes of millions of Americans, dramatically boosting the popularity and profitability of the sport.

The Business of NASCAR

Unlike most team sports, there is no amateur draft in NASCAR. Nor do you have to finish in the top 125 on the money list to keep your playing exemption, as you do in golf. In NASCAR, if you can convince someone that you are good enough to race competitively and to pay for your team of mechanics and crew chiefs, you are ready to go. A company may have three or four teams. For example, in 1996, Hendrick Motorsports had teams for three drivers: Jeff Gordon, Terry Labonte, and Ricky Craven. Each of Hendrick's teams cost about \$7.5 million to operate that year. Another \$7.5 million went into joint efforts, such as car development. How does Hendrick pay for this? Far and away the biggest source of income comes from corporate sponsors who pay to advertise on a team's car and uniforms. About 55 percent of Hendrick's revenues in 1996 came from sponsorships. That year, the top sponsors were DuPont, Kellogg's, and Anheuser-Busch. Roughly 10 to 15 percent came from race winnings (which are split 50/50 between the driver and the



Richard Petty, known to many fans as simply “The King,” is arguably the greatest NASCAR driver of all time, having won 200 races, including seven at the Daytona 500.

organization), 10 percent from the sales of collectibles, 10 percent from research projects sponsored by General Motors, and 10 percent from leasing engines to other drivers.

Why are sponsors willing to put up so much money to sponsor a NASCAR team? According to Rubbermaid, which sponsors Kurt Busch's No. 97 car, the answer is a high degree of brand loyalty combined with ideal demographics. More than 75 percent of NASCAR fans are in the 18-to-54 age bracket and, according to Rubbermaid, about 40 percent will switch to a product if it becomes a NASCAR sponsor.

“Since birth, NASCAR has understood how expensive it is to participate in stock car racing. Whereas baseball, football, and basketball all started with a fairly low operating base, which allowed owners to make a decent profit on their investment, the sport of stock car racing began with a substantial financial burden,” writes Hagstrom. “In order to survive, the sport had to master the sponsorship relationship. Today's fans know how important the sponsors are; so do the drivers.”

Team owners also understand that it pays to take advantage of economies of scale. That's why many sponsor multiple teams. Consider Hendrick Motorsports. Rick Hendrick, the company's

president, owned car dealerships throughout the South before entering the world of NASCAR in 1984. At first, Hendrick had just one driver: Geoff Bodine. Later, Tim Richmond, Darrell Waltrip, and Ken Schrader entered the fold. All those drivers eventually left — Richmond died and Bodine, Waltrip, and Schrader went on to other companies — but the business advantage of running more than one team had become clear to Hendrick. So he quickly recruited new drivers to his company. “I related racing to the automobile business,” Hendrick told *Stock Car Racing*. With his car dealerships, Hendrick had learned that by “being able to share information we were more successful. I could think of no reason why the same theory wouldn't work in NASCAR.” Since Gordon signed with Hendrick, he has won four Winston Cup championships and is now mentioned in the same breath with such all-time greats as Richard Petty and the late Dale Earnhardt.

The Framework for Success

A few years after Big Bill France organized NASCAR, he founded Bill France Racing Inc. It was this company that officially owned the track at Daytona — and which now goes by the name of the International Speedway Corporation

(ISC). The two organizations — NASCAR and ISC — are often thought of synonymously, mainly because they are both still run by the France family. But according to Doug Fritz, president of the Richmond International Raceway, it's important to distinguish between the two. NASCAR, Fritz says, is the sanctioning body for the sport. In other words, it is a league office, much like the one headed by David Stern of the National Basketball Association or Paul Tagliabue of the National Football League. ISC, on the other hand, is a publicly held company that owns 12 major racetracks — including Fritz's track in Richmond — and promotes more than 100 events each year.

Over time, ISC has branched out from the Southeast and built tracks in once-unlikely places such as San Bernardino County, Calif., Phoenix, Ariz., and Kansas City, Kan. In addition, Tony Stewart, the 2002 Winston Cup champion, is a native of Indiana. And Gordon, arguably the sport's biggest star, also hails from outside the Southeast; he was born in California.

Stock car racing, according to one author, has gone “From Moonshine to Madison Avenue.” And while long-time fans and employees of the sport may think that statement is a bit hyperbolic, there is some truth to it. Certainly, the sport has come a long way since that first race in a Georgia pasture. **RF**

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Menzel, Joe. *The Wildest Ride: A History of NASCAR (or How a Bunch of Good Ol' Boys Built a Billion-Dollar Industry out of Wrecking Cars)*. New York: Simon & Schuster, 2001.

Visit www.rich.frb.org/pubs/regionfocus for links to relevant Web sites.

District Economic

BY ROBERT LACY

Fifth District economic growth was modest in the first quarter of 2003 as consumers and businesses adopted a “wait and see” posture toward spending in light of political and military developments in Iraq. Employment levels were little changed from a year ago, although unemployment rates did inch lower. With the Iraq war over, Fifth District businesses expect economic conditions to improve, but few anticipate a quick turnaround.

Did You Know...

Most people who work in the District of Columbia don't live there. They reside in Maryland or across the Potomac River in Virginia instead. According to the 2000 Census, 279,000 people who worked in D.C. claimed residence in Maryland, and another 191,000 claimed residence in Virginia. Two Maryland counties — Prince George's and Montgomery — were home to one out of three D.C. workers.

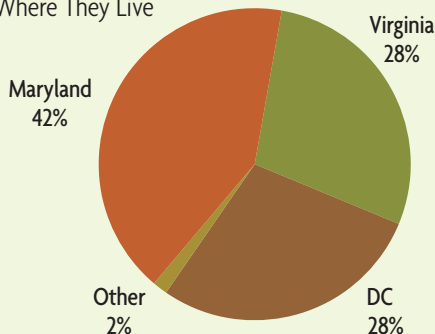
Economic growth in the Federal Reserve's Fifth District was modest in the first quarter of 2003. Consumers tightened purse strings amidst a host of worries: war in Iraq, threats of domestic terrorism, and continued job layoffs in manufacturing. Many businesses hunkered down as well, opting to delay capital spending and new hiring in the face of considerable economic uncertainty.

Subpar Economic Growth

District retail and services businesses we survey reported sluggish business conditions in most sectors during the first quarter of 2003. Activity was particularly weak in February, partly as a result of unusually severe ice and snow storms in the region. But the economic uncertainty stemming from political and military developments in Iraq and the threat of domestic terrorism also dampened growth throughout the quarter.

District retailers tell us their revenues continued to slip and that employment edged down in recent months, and their comments are borne out by the data. According to the Bureau of Labor Statistics, retail employment in Fifth District states in March was below the level of four years earlier. And because of the uncertainty associated with the conflict in Iraq, the retail outlook was also cloudy. A men's clothing retailer in Charleston, W.Va., captured the sentiment of a number of Fifth District retailers in April, reporting “We're stuck in the mud until we get the war over. ...”

Workers in Washington, D.C.
Where They Live



The path of manufacturing was less direct. District manufacturers appeared to be rebounding early in the first quarter of 2003 — both shipments and new orders surged in January. But shipments flattened in February and March, and new orders began to tumble. Manufacturing employment also fell — once again. Five percent of manufacturing jobs in the Carolinas were lost in the last year alone.

Mixed Signals in Labor Markets

The average unemployment rate in Fifth District states was 5.1 percent in the first quarter of 2003, well below the national rate of 5.8 percent. What's more, the regional rate has drifted down since peaking at 5.5 percent in the first half of 2002, indicating some strengthening in the regional economy.

But the Labor Department reports that payroll employment in the region was off 0.2 percent in the first quarter compared to a year ago, suggesting weaker economic conditions. Employment in government and some services industries — health care and education, for example — expanded over the year. These gains, however, were more than offset by declines in the goods producing sector, particularly in manufacturing.

Such contrasting views of labor market conditions can be reconciled in part by recognizing that some workers may have become discouraged about job prospects and left the labor force. While the ranks of the unemployed have declined in the Fifth District over the last year, one would like to see more job growth before concluding that labor market conditions have turned around.

Waiting for a Lift

The fall of Baghdad and the end of widespread conflict in Iraq in April brought renewed hope that economic growth would pick up again. Fifth District manufacturers remain cautious, however, reiterating that the manufacturing sector was struggling before the war in Iraq and was unlikely to rebound quickly with the end of the conflict. As of May 2003, we were still awaiting evidence of acceleration in growth.

Developments

Nonfarm Employment First Quarter 2003

	Employment (Thousands)	% Change (Year Ago)
DC	666	0.7
MD	2,471	-0.2
NC	3,830	-0.5
SC	1,803	0.2
VA	3,482	-0.3
WV	734	-0.1
5th District	12,986	-0.2
US	130,596	-0.1

Unemployment Rate Percent

	1st Qtr. 2003	1st Qtr. 2002
DC	6.4	6.5
MD	4.3	4.5
NC	6.0	6.9
SC	6.1	6.0
VA	4.1	4.3
WV	5.7	5.7
5th District	5.1	5.5
US	5.8	5.6

Personal Income Fourth Quarter 2002

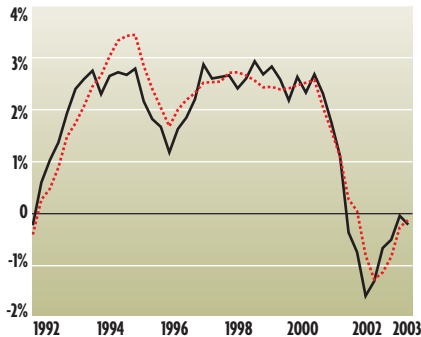
	Income (\$ billions)	% Change (Year Ago)
DC	24.3	4.4
MD	201.4	5.4
NC	233.1	4.1
SC	105.6	4.4
VA	243.9	4.5
WV	43.2	3.8
5th District	851.6	4.5
US	9,035.0	3.9

— Fifth District

- - - United States

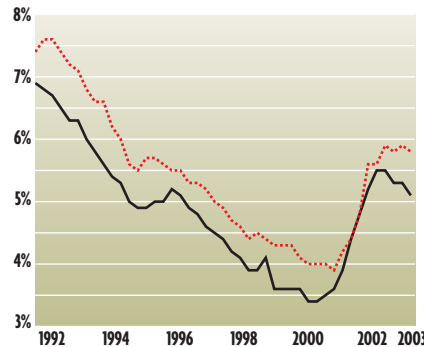
Nonfarm Employment Change From Prior Year

First Quarter 1992 - First Quarter 2003



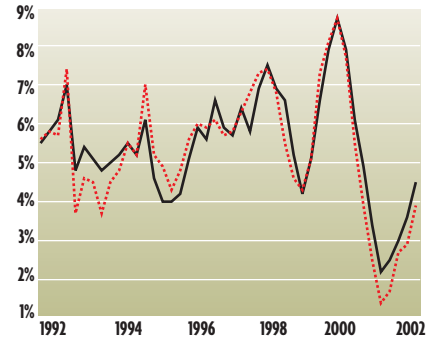
Unemployment Rate

First Quarter 1992 - First Quarter 2003



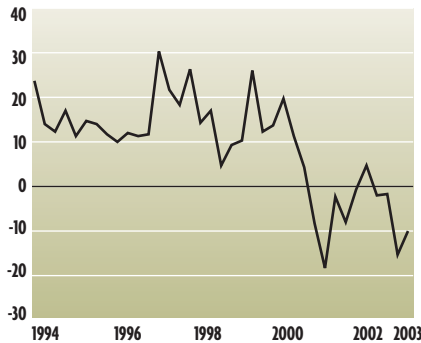
Personal Income Change From Prior Year

First Quarter 1992 - Fourth Quarter 2002



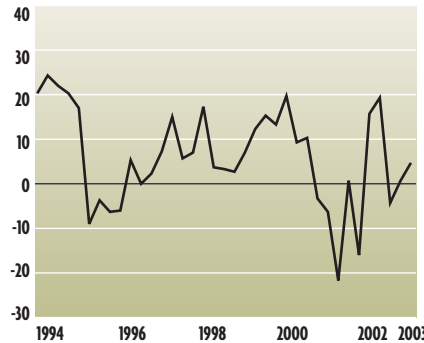
FRB—Richmond Services Revenues Index

First Quarter 1994 - First Quarter 2003



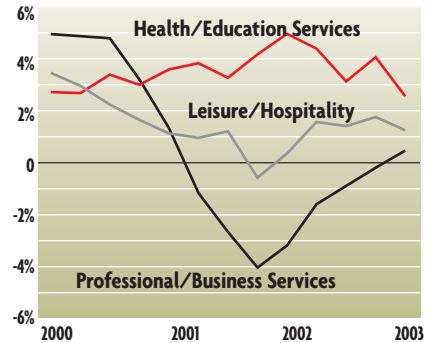
FRB—Richmond Manufacturing Shipments Index

First Quarter 1994 - First Quarter 2003



Fifth District Employment Selected Industries—Change From Prior Year

First Quarter 2000 - First Quarter 2003



NOTES:

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

SOURCES:

Income: Bureau of Economic Analysis, U.S. Department of Commerce, <http://www.bea.doc.gov>
Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>
Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>

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DISTRICT OF COLUMBIA

BY ANDREA HOLLAND

Structural changes within the U.S. economy in recent decades made the existing economic classification system increasingly obsolete and necessitated the development of a new system. In response, the Standard Industrial Classification (SIC) system — in place since 1941 — was replaced by the new North American Industry Classification System (NAICS). Payroll data for the District of Columbia were converted to NAICS in March 2003, with the release of the January 2003 Current Employment Survey (CES).

The production-based NAICS data present a fresh view of the District of Columbia's work force. Jobs are classified as either goods-producing or service-providing. In early 2003, 97.8 percent of all jobs in the District of Columbia were grouped under service-providing and only 2.2 percent were classified as goods-producing.

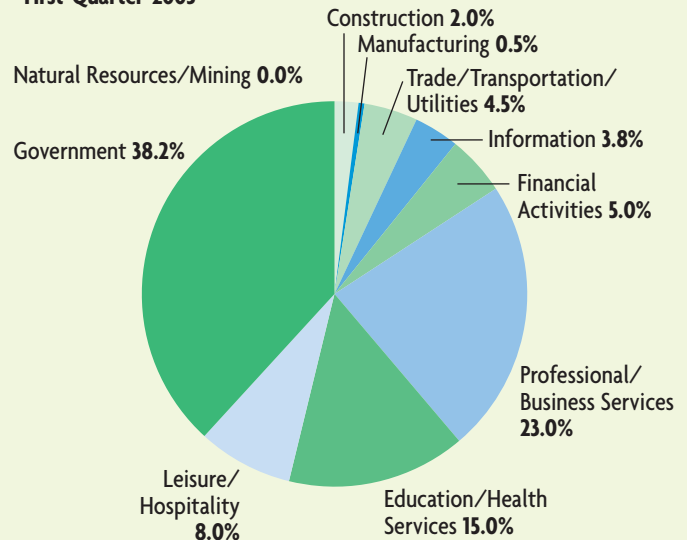
With its large share of service jobs, the District of Columbia ranks first in its percentage of professional and business services and information jobs in the Fifth District. And as the nation's capital, it also has the largest portion of government jobs. On the flip side, the District of Columbia hosts the Fifth District's smallest percentage of manufacturing, construction, and natural resources and mining jobs.

Although aggregate payroll numbers remain roughly unchanged under NAICS, a number of the District of Columbia's former goods-producing jobs have been reclassified as service-providing. For example, the portion of manufacturing jobs shrank from 1.7 percent to 0.5 percent because printing and publishing jobs were moved from manufacturing (goods-producing) to the new information (service-providing) sector.

Because national job weakness has been centered in manufacturing, the District of Columbia's sparse dependence on goods-producing jobs enabled it to weather the current recession better than other Fifth District states. In fact, since the recession began in the first quarter of 2001, the aggregate employment level has steadily increased. Most recently, first-quarter payrolls in the District of Columbia were 1.8 percent higher than in late 2002, and the unemployment rate dropped off 0.1 percentage points.

News also remained generally favorable in the District of Columbia's residential real estate markets. New building permit activity was particularly strong in the first quarter — fueled in part by favorable interest rates and strong wage and salary growth.

DC Employment Composition by Sector First Quarter 2003



SOURCES:
Bureau of Labor Statistics/Haver Analytics
Personal Income, U.S. Department of Commerce, Bureau of Economic Analysis/Haver Analytics

	Percent Change at Annual Rate From		
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Nonfarm Employment	666.0	1.8	0.7
Manufacturing	2.8	-13.1	-11.6
Professional/Business Services	139.9	2.5	0.9
Construction	12.0	-36.7	12.8
Civilian Labor Force	304.2	2.8	-0.8
Home Sales	13.7	-39.0	-2.8
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Unemployment Rate	6.4	6.5	6.5
Housing Permits	619	394	54

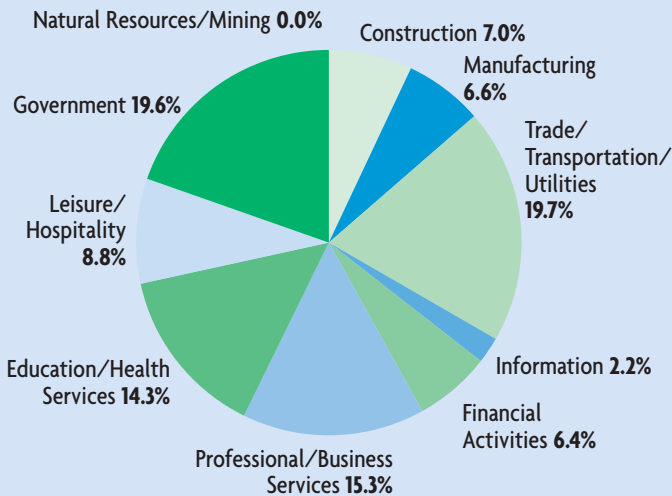
NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Construction, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Housing Permits, number of permits, not seasonally adjusted; U.S. Census Bureau/Haver Analytics

Construction totals include natural resources and mining employment.



BY ANDREA HOLLAND

MD Employment Composition by Sector First Quarter 2003



SOURCES:
Bureau of Labor Statistics/Haver Analytics
Personal Income, U.S. Department of Commerce, Bureau of Economic Analysis/Haver Analytics
Metro Area Office Vacancy Rates, CB Richard Ellis/Haver Analytics

	Percent Change at Annual Rate From		
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Nonfarm Employment	2,471.3	-0.1	-0.2
Manufacturing	154.5	0.4	-3.7
Professional/Business Services	360.9	-4.6	-0.3
Construction	165.7	-14.8	4.7
Civilian Labor Force	2,929.1	4.0	1.3
Home Sales	132.3	14.5	4.0
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Unemployment Rate	4.3	4.2	4.5
Housing Permits	5,931	6,488	6,908

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Construction, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Housing Permits, number of permits, not seasonally adjusted; U.S. Census Bureau/Haver Analytics

Construction totals include natural resources and mining employment.

After 60 years of use, the Standard Industrial Classification (SIC) system was recently replaced by the new North American Industry Classification System (NAICS). The movement to upgrade the SIC system stemmed largely from increasing difficulty in classifying new industries, a byproduct of the SIC system's somewhat vague demand- and supply-side approach to classification. In contrast, NAICS uses a production-based concept of classification — an establishment is assigned to an industry based on “how” it produces or provides, not “what” it produces or provides.

Maryland employment numbers were converted to NAICS with the release of the January 2003 Current Employment Survey (CES). The updated job numbers show that Maryland is dominated by service-providers — firms in the category accounted for over 87.2 percent of total employment in early 2003. Within Maryland's service-providing domain, trade, transportation, and utilities jobs account for the largest portion of total employment, followed closely by government and professional and business services.

Maryland held the largest percentage of construction jobs in the Fifth District under the SIC classification system, and the state's lead widened with the conversion to NAICS. Construction's share increased partly because highway maintenance workers — grouped in government under SIC — were moved into construction under NAICS. Maryland also ranks first in the Fifth District in its portion of financial activities jobs; this new sector encompasses most of the SIC finance, insurance, and real estate sector and adds a smattering of jobs formerly grouped under the SIC services, transportation, communications, and public utilities sectors.

The latest data point to continued weakness in Maryland's overall job numbers. The leisure and hospitality sector was especially hard hit, due, in part, to adverse weather conditions early in the year. In line with the slight contraction in payrolls, Maryland's unemployment rate inched up 0.1 percentage point to reach 4.3 percent in early 2003.

But on a more positive note, total personal income grew at a 5.7 percent annual rate in the fourth quarter, easily outpacing the national and Fifth District growth rates. Likewise, new home sales peaked at 132,300, up 4 percent over the year, and metropolitan area office vacancy rates declined for the first time since early 2002.



NORTH CAROLINA

BY ANDREA HOLLAND

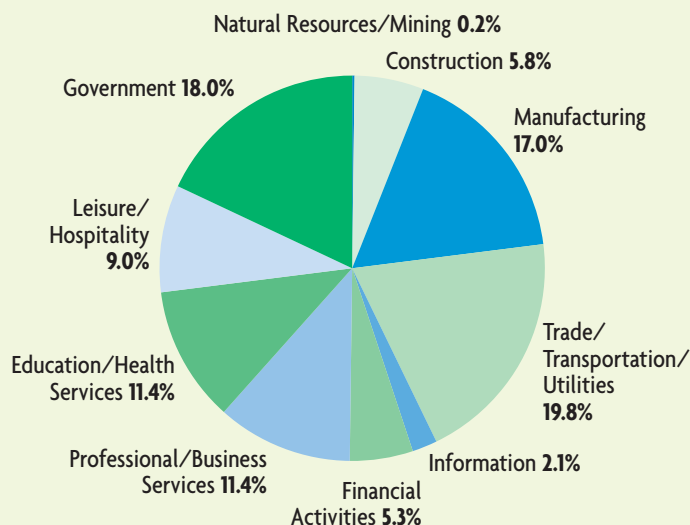
The Standard Industrial Classification (SIC) system was developed at a time when manufacturing dominated the U.S. economy. Since then, changes in the economy have diminished the role of manufacturing but boosted the significance of other industries. To reflect these changes, the SIC system was replaced by the North American Industry Classification System (NAICS) in the late 1990s. Shortly afterward, the Bureau of Labor Statistics (BLS) began the multiyear task of integrating the new system across their statistical programs. North Carolina payroll employment data were converted to NAICS in March 2003, with the release of the January 2003 data.

The proportion of North Carolina service-providers rose under NAICS while the share of goods-producers lost ground. The majority of jobs transferred into the service-providing domain came from the manufacturing sector — construction and natural resources and mining payrolls remained relatively unchanged.

In contrast to SIC, NAICS uses a production-based concept of industry classification. As a result, a number of manufacturing jobs not directly linked to production were extracted and redefined as service-providing “auxiliary establishments.” Auxiliary establishments provide management or support services to other organizations within the same company. While the SIC system grouped auxiliary establishments in the same industry as the parent company, NAICS classifies them according to the services they provide. For example, accounting divisions at North Carolina furniture manufacturers are no longer classified under manufacturing. Instead, they now reside under financial activities, a service-providing sector.

With the shift to NAICS, manufacturers now employ less than a fifth of North Carolina’s work force, and payroll numbers in the sector continue to dwindle. Factory payrolls declined 5.1 percent in early 2003, marking the twentieth consecutive quarter of contraction. But aggregate payrolls edged only slightly lower and the unemployment rate dropped sharply — jobs added in trade, transportation, and utilities, professional and business services, leisure and hospitality, and education and health services helped offset large losses in the goods-producing industries.

NC Employment Composition by Sector First Quarter 2003



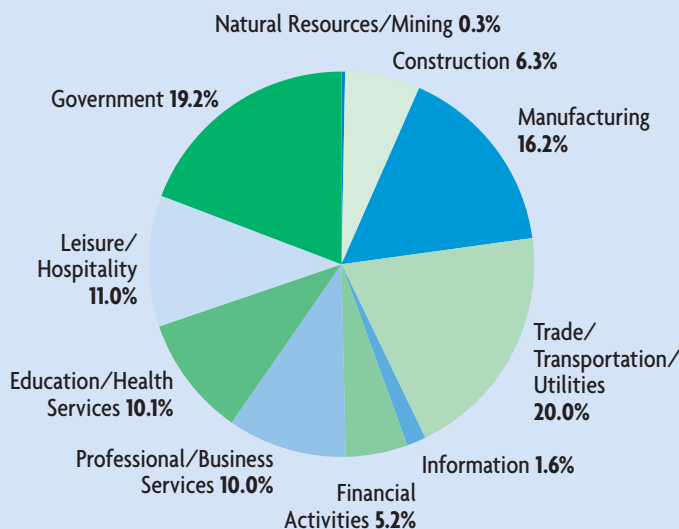
SOURCE:
Bureau of Labor Statistics/Haver Analytics

	Percent Change at Annual Rate From		
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Nonfarm Employment	3,829.8	-0.1	-0.5
Manufacturing	619.0	-5.1	-5.8
Professional/Business Services	417.3	3.2	1.0
Construction	213.0	-7.6	-7.2
Civilian Labor Force	4,157.8	0.2	-0.8
Home Sales	257.1	10.8	3.4
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Unemployment Rate	6.0	6.6	6.9
Housing Permits	17,122	20,963	18,858

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Construction, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Housing Permits, number of permits, not seasonally adjusted; U.S. Census Bureau/Haver Analytics

BY ANDREA HOLLAND

SC Employment Composition by Sector First Quarter 2003



SOURCES:
Bureau of Labor Statistics/Haver Analytics
Personal Income, U.S. Department of Commerce, Bureau of Economic Analysis/Haver Analytics

	1st Qtr 2003	Percent Change at Annual Rate From	
		4th Qtr 2002	1st Qtr 2002
Nonfarm Employment	1,802.5	-3.6	0.2
Manufacturing	281.7	-10.3	-3.9
Professional/Business Services	174.0	-19.7	-1.6
Construction	109.8	-3.9	-1.1
Civilian Labor Force	2,026.2	9.1	3.6
Home Sales	131.4	11.4	10.5
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Unemployment Rate	6.1	6.2	6.0
Housing Permits	8,439	6,711	8,136

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Construction, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Housing Permits, number of permits, not seasonally adjusted; U.S. Census Bureau/Haver Analytics

The Standard Industrial Classification (SIC) system was implemented in 1941 to help gauge economic activity. It classified industries by either their production process or market group. A drawback to this approach was that if two end products had similar production processes — but were sold in different market groups — they could still end up being classified in different industries. Over the years, the introduction of new technologies exacerbated this problem and reduced the accuracy and usefulness of the SIC system in tracking industry data — employment conditions in particular.

To address these concerns, the SIC system was replaced by the North American Industry Classification System (NAICS) in 1997, and South Carolina payroll data were converted to the new system in March 2003. The updated employment data reveal that South Carolina has the least diversified work force in the Fifth District outside of North Carolina.

Manufacturing jobs account for the bulk of South Carolina's goods-producing domain. Although North Carolina still ranks first in its share of factory employment, South Carolina has narrowed the gap with the conversion to NAICS.

The service-providing domain is also more concentrated by industry in South Carolina than in other Fifth District jurisdictions. The state has the smallest percentage of education and health services and information jobs. In contrast, the state has the largest percentage of leisure and hospitality jobs.

Aggregate payrolls in South Carolina were reduced by over 16,000 in the first quarter of 2003 — the largest drop in over a year. But not all of the economic news was bad for South Carolina. Total personal income grew at a 3.8 percent annual rate in the fourth quarter of 2002, outpacing the growth rate nationally. Likewise, new home sales rose 10.5 percent over the year. And despite the significant drop in payroll numbers, the unemployment rate declined 0.1 percentage points to reach 6.1 percent in early 2003. The disparity between the two indicators of employment conditions stem from the use of two different surveys to gauge employment conditions — one asks establishments, while the other tracks households.



VIRGINIA

BY ANDREA HOLLAND

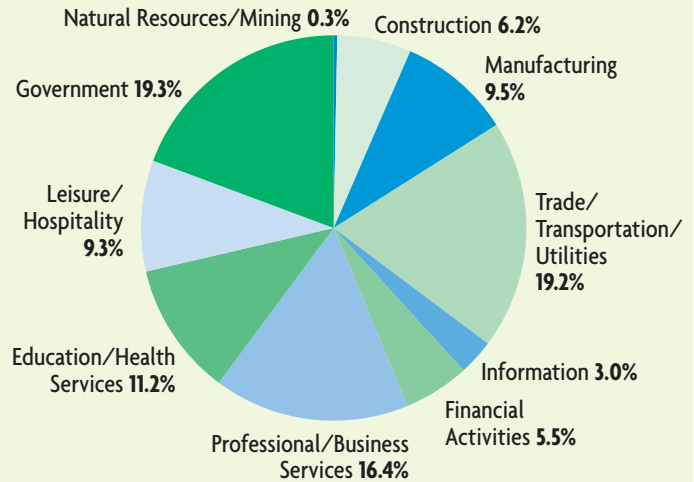
The Standard Industrial Classification (SIC) system, in use for more than 60 years, was gradually phased-out beginning in 1997 and replaced with a new classification scheme. The push for change stemmed from the SIC system's inability to portray significant structural changes to the economy that have occurred over time. Specifically, the system had difficulty in classifying new, service-oriented industries. Replacing SIC is the new North American Industry Classification System (NAICS), which uses a production-based concept of classification — establishments are assigned to an industry based on “how” they produce or provide not “what” they produce or provide.

Virginia payroll numbers were converted to NAICS beginning in March 2003. The updated figures show that Virginia's employment distribution is the most diversified in the Fifth District. Job numbers are relatively balanced across most sectors, and Virginia ranks at neither the top nor bottom in terms of employment share by industry. The largest sectors in Virginia are government and trade, transportation, and utilities. Alternately, the natural resources and mining super-sector employs the smallest proportion of Virginians.

A significant change under NAICS is the creation of the new information sector. Although this category currently accounts for only 3.1 percent of total employment in Virginia, the number of information jobs in the state nearly doubled in the 1990s, before dropping off sharply in 2001. The new sector is a fusion of industries, which under the SIC system were spread across manufacturing, communications, business services, and amusement services. Recent data suggest possible improvement at Virginia's information establishments — payrolls were up 0.5 percent in the first quarter, the first gain in two years.

But other data reveal that overall payroll conditions were not as rosy in the first quarter. Aggregate employment in Virginia fell by 1.8 percent in early 2003 — the largest quarterly decline recorded since late 2001. The unemployment rate also rose 0.2 percentage points in the first quarter of the year. But the fourth-quarter personal income figure was 4.5 percent higher over the year, matching wage and earnings growth for the Fifth District as a whole. Consumers transferred some of these earnings into the housing market — new home sales reached a record level in early 2003 and were 3.7 percent above year-ago levels.

VA Employment Composition by Sector First Quarter 2003



SOURCES:
Bureau of Labor Statistics/Haver Analytics
Personal Income, U.S. Department of Commerce, Bureau of Economic Analysis/Haver Analytics

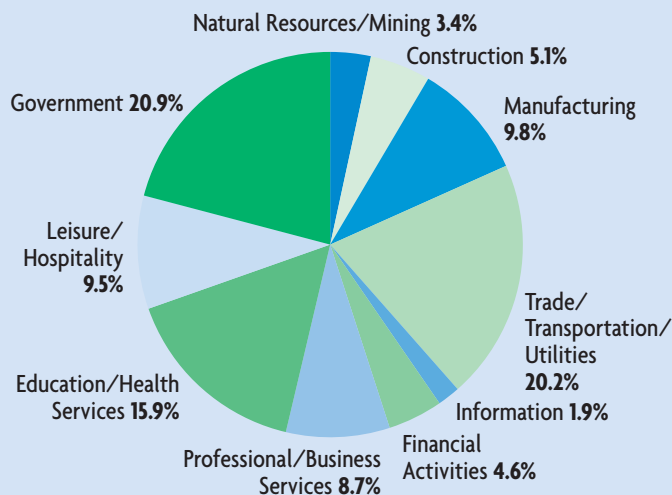
	Percent Change at Annual Rate From		
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Nonfarm Employment	3,482.5	-1.8	-0.3
Manufacturing	313.4	-7.2	-3.3
Professional/Business Services	541.5	-1.7	-1.2
Construction	205.5	-7.8	-4.3
Civilian Labor Force	3,793.0	6.0	1.7
Home Sales	170.2	8.4	3.7
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Unemployment Rate	4.1	3.9	4.3
Housing Permits	13,278	14,262	14,341

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Construction, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Housing Permits, number of permits, not seasonally adjusted; U.S. Census Bureau/Haver Analytics



BY ANDREA HOLLAND

WV Employment Composition by Sector First Quarter 2003



SOURCES:
Bureau of Labor Statistics/Haver Analytics
Personal Income, U.S. Department of Commerce, Bureau of Economic Analysis/Haver Analytics

	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Nonfarm Employment	733.5	2.6	-0.1
Manufacturing	66.4	-6.9	-4.8
Professional/Business Services	59.0	12.1	4.9
Construction	34.7	22.7	0.2
Civilian Labor Force	806.6	6.4	-0.9
Home Sales	27.8	-19.0	-2.8
	1st Qtr 2003	4th Qtr 2002	1st Qtr 2002
Unemployment Rate	5.7	6.2	5.7
Housing Permits	860	992	894

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Construction, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Housing Permits, number of permits, not seasonally adjusted; U.S. Census Bureau/Haver Analytics

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

For over 60 years, the Standard Industrial Classification (SIC) system was the primary tool used to determine the industry category of individual businesses. But changes in the economy over time diminished the SIC system's ability to accurately portray the structure of the U.S. work force — creating the need for a new method of industry classification. Recognizing these deficiencies, the federal government replaced the SIC system with the North American Industry Classification System (NAICS) in 1997. Shortly after, the Bureau of Labor Statistics began the multiyear task of converting their existing statistical programs to NAICS, but it was not until March 2003 that state payroll data were converted to the new system.

The new payroll data show that West Virginia has the smallest share of professional and business services and financial activities jobs in the Fifth District. On the flip side, the state has the largest percentage of trade, transportation, and utilities employees and the second-largest share of leisure and hospitality payrolls. Under NAICS, some of West Virginia's trade-related employees were reclassified into the newly created leisure and hospitality supersector. More specifically, because NAICS uses a production based concept of classification, eating and drinking places (formerly under the SIC retail trade division) were relocated under leisure and hospitality.

West Virginia also ranks first among Fifth District states in its share of education and health services and natural resources and mining employment. Under the NAICS system, the mining and agriculture, forestry, and fishing divisions were absorbed into the natural resources and mining sector — a fusion of industries that profit from extracting resources from the environment. Most recent data show a moderate pickup at these establishments — 467 jobs were added in the first quarter, marking the first quarterly expansion since late 2001.

Other measures suggest positive economic news for the state. After contracting throughout 2002, the aggregate employment level in West Virginia rose 2.6 percent in early 2003 and the jobless rate dropped 0.5 percentage points to 5.7 percent. Total personal income grew at a 3.9 percent annual rate in the fourth quarter, outpacing activity nationally. Downside risks were still evident, though. Real estate conditions remained sluggish in West Virginia in the first quarter of the year; new home sales dropped off and building permit authorizations eased moderately.

Don't Bring Back the Draft

BY AARON STEELMAN

For most of American history, the U.S. military has been populated by volunteers. During the two World Wars, the Korean War, and the Vietnam War, however, a draft was used. During the late 1960s, many people began to question the efficiency and fairness of conscription. Eventually, these skeptics — including some prominent economists — persuaded President Nixon to allow the draft to lapse. Since July 1, 1973, the United States has once again had a volunteer military.

But not everyone is convinced that this is a good idea. In fact, following the terrorist attacks of Sept. 11, 2001, a growing number of people — from across the political spectrum — have been calling for Washington to reinstate the draft. These supporters of conscription employ many arguments. But there are three claims that stand out above the rest.

First, an army of conscripts would be cheaper than an army of volunteers. Charles Moskos, a sociologist at Northwestern University, and Paul Glastri, editor of *The Washington Monthly*, bluntly state, “Draftees would not have to be offered the relatively high wages and benefits that it takes to lure voluntary recruits (an increasing number of whom are married with families).”

Second, the volunteer army relies too much on the labor of the poor and minorities, especially blacks, and a draft would help correct this inequity. Gail Buckley, author of *American Patriots: The Story of Blacks in the Military from the Revolution to Desert Storm*, writes, “The military may be all-volunteer, but ... poorer whites and minorities enlist. Why should those who can't afford to go to college be the only young people who have to go to war?”

Third, young people don't appreciate the freedoms that they enjoy as Americans, and if they were required to serve in the military, they might become less complacent. Stanley Kurtz, a research fellow at the Hoover Institution at Stanford University, has summed up this sentiment nicely. After Pearl Harbor, “America's men simply took it for granted that they would serve. In fact, they were eager to fight — to strike back for what had been done to America,” Kurtz writes. “But the truth is, many young people no longer share the eagerness of the ‘greatest generation’ for battle.”

Let's take these arguments in turn. It is true that the government would not have to pay conscripts as much as volunteers. But this does not mean that a conscript army is “cheaper” in any real sense. By drafting a soldier you are imposing a tax on him, equal to the difference between the wage at which he

would join the military on his own and the wage he actually receives. “This implicit tax in kind should be added to the explicit taxes imposed on the rest of us to get the real cost of our Armed Forces,” explained economist Milton Friedman. By ignoring such costs, one could argue that “the construction of the Great Pyramid with slave labor was a cheap project.”

Conscripts also tend to serve fewer years than volunteers. Indeed, during the Vietnam War, most conscripts left the military once they were legally able. In contrast, most volunteers today sign on for more than one hitch. This results in significantly lower training costs. What's more, volunteers, on average, enter the military with greater skills than conscripts, further reducing training costs.

Also, by keeping the cost of labor artificially low, a draft encourages the military to use enlisted men for tasks that could be done by machines. With conscription, “it pays to hoard labor, to use it wastefully, and to adopt capital-to-labor-ratios that are too low,” stated economist George Hildebrand.

The racial balance of the military is not, in fact, skewed toward one particular group. In a recent report opposing the reinstatement of the draft, the Department of Defense stated, “Today, black recruits closely parallel their representation among the youth population.” What's more, blacks “tend to be concentrated in administrative and support jobs, not in combat jobs.” Blacks account for 21 percent of the enlisted force, but make up only 15 percent of combat troops.

Finally, it's hard to rebut the claim that young people are “soft” or don't fully appreciate the importance of America's military and traditions. Those are essentially value judgments. How much weight you give to them depends on your perspective. But such claims must be balanced against another important and widely held value: individual freedom. Most people would agree that the government should have a compelling reason to force someone to do something he otherwise wouldn't. And it's not clear, for the reasons stated above, that forcing people into military service is such a reason. Indeed, as Doug Bandow, author of *Human Resources and Defense Manpower*, has asked rhetorically: “Is a military healthier if it relies on those who desire to serve and succeed or if it is forced to include those who desire to escape at any price?”

America's experience with a volunteer military hasn't been perfect, to be sure. But our country is safer and freer under such a system than under conscription.

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“One strength of the volunteer army lies in its compatibility with our heritage of individual freedom; indeed, no other alternative is.”

ECONOMIST JAMES C. MILLER III

No Vacancy?

The real estate market in the Fifth District was booming just a few years ago. But some of the hottest spots have now turned relatively cold. And a few that missed out on the boom are experiencing rapid growth. What explains this reversal of fortune? And what might the future hold?

Media Consolidation

The Federal Communications Commission recently loosened rules that restrict newspapers from owning television stations in the same market. How will this change affect media companies in the Fifth District? And will it silence important, alternative voices?

The Business of Trees

Many people think that only environmentalists value trees. But a growing number of business people are showing that this isn't true. For instance, the Fifth District is home to many privately owned and managed forests. Find out why.

Economic Education

The Federal Reserve System has an extensive economic education program, designed to increase economic and financial literacy among teachers, students, and the general public. We'll look at what the Richmond Fed does to achieve this goal.

The National Road

In the early 19th century, Congress earmarked funds for the National Road, which linked Cumberland, Md., to Wheeling, WVa., and points west. The road opened Midwestern markets to Eastern merchants and stimulated economic growth along the route. It also provided a glimpse at how interstate highways would alter the American landscape in the 20th century.

Interview

A conversation with Mickey Levy, chief economist at Bank of America.

Jargon Alert

Economists often argue that public policies should be subjected to "cost-benefit analysis." An examination of what that means.

Legislative Update

Federal lawmakers recently cut taxes on dividends. How might this feature of the tax bill affect the economy?

Research Spotlight

Allocating the commons: The case of parking on public roads.

The Fall 2003 REGIONFocus will be published in October.

Articles will also be available online at www.rich.frb.org/pubs/regionfocus.

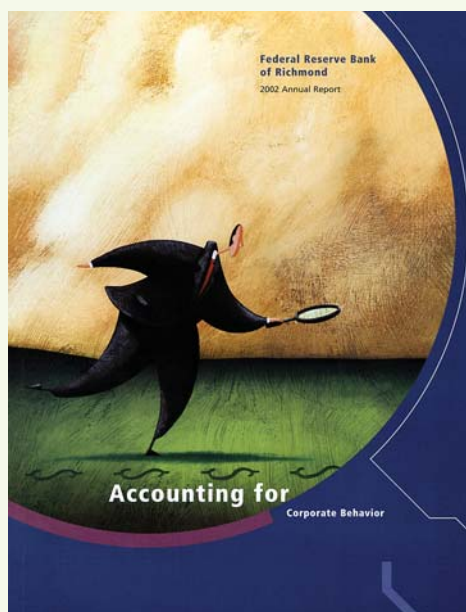
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The Challenges of Corporate Governance

The strength of corporate governance arrangements in American corporations became a subject of hot debate in 2002 as accounting scandals unfolded at several large firms. The attention received by the scandals and the legislative response — Congressional passage of the Sarbanes-Oxley Act — may give the impression that the American system of corporate governance was fundamentally flawed. Is that impression true?

In the Richmond Fed's *2002 Annual Report* feature article, "Accounting for Corporate Behavior," a senior Bank economist looks at the debate in terms of the fundamental challenge in governance arrangements — a company's need to align the incentives of managers with those of widely dispersed shareholders. He contends that there are strong *market forces* that lead managers to adopt governance structures that encourage investors' trust. And, if those forces fall short, government intervention alone may not bring about dramatic changes in corporate behavior.

The *Annual Report* also includes a message from the president and first vice president, in which they discuss the national and Fifth District economies, and an overview of the Bank's 2002 financial activity.



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