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» An Interview with Randall Kroszner » Is Greenspan a Wicksellian?

# REGION FOCUS

WINTER 2004

THE FEDERAL RESERVE BANK OF RICHMOND



## Hanging by a Thread

A Look Inside  
America's Struggling  
Manufacturing Sector

# REGION FOCUS

VOLUME 8  
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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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## If Free Trade Is So Good, Why Don't We Have More of It?



**“While the economics of trade restrictions seem clear, the politics of the matter are much more complicated.”**

**D**o you know the old saying, “lay a hundred economists end-to-end and they still wouldn’t reach a conclusion”? It suggests that members of my profession can have a hard time reaching a consensus, and there certainly are significant disagreements among economists on some important issues, such as the effects of government deficits or the optimal degree of progressivity in income taxes. There are some matters, however, on which there is broad agreement among economists, and a prime example is the benefits of free trade. Unhindered access to markets in developed countries offers the best hope for growth in the world’s poorest countries. In the developed world, trade generates significant benefits to consumers. In general, trade allows all countries to enjoy the substantial gains from specialization in production. Most economists acknowledge that the opportunities for growth in all the world’s wealth would be greatest if there were few barriers to the trade that allows countries to produce according to their comparative advantage.

If the benefits of free trade are so widely recognized by economists, then why are the liberalization of trade and the removal of barriers so elusive? Setting aside the flip answer that nobody listens to economists, I think that while the economics of trade restrictions seem clear, the politics of the matter are

much more complicated. This is true for a number of reasons. For one thing, the costs of barriers are spread widely among all consumers in an economy, while the benefits accrue to a much narrower set of people involved in the production of the goods subject to the restriction. So those who stand to benefit from barriers to trade are better able to mobilize as an interest group to exert influence on the political process. The geographic concentration of some manufacturing industries, such as the textile and apparel industries in the Fifth District, only serves to enhance the political attractiveness of import restrictions. Our cover story makes clear how intensely import competition can be felt in affected communities.

Another factor that can complicate the actual making and implementation of trade policy is the possible interdependence of one country’s policy with that of its trading partners. While it might be easy to convince people of the widespread benefits of eliminating all the world’s trade barriers in one fell swoop, it would be challenging—to put it mildly—to actually do so in practice. In an imperfect world, where trading partners maintain an array of quotas and tariffs, it might be beneficial in some cases for an individual country to maintain barriers of its own.

And even if a country could generate significant net economic benefits for its citizens from a unilateral reduction of trade barriers, such a move can be a tough sell on the domestic political front. Consequently, movements toward reduced barriers to trade take place mostly through multilateral, regional agreements, such as NAFTA, or Mercosur in Latin America, or globally through the World Trade Organization.

The textbook case for free trade is based on the simple and powerful economics of comparative advantage, which I’ve talked about before on these pages. The complications of the real world do not render that case invalid. They do, however, make consensus on movement toward more liberalized trade policies difficult to achieve. I believe that making a persuasive, nontechnical case for free trade should be a top priority for the economics profession. This would help the public appreciate that, overall, it stands to gain much more from free trade than it stands to lose.

AL BROADDUS  
PRESIDENT  
FEDERAL RESERVE BANK OF RICHMOND

# Two-Way Street

## The Board of Directors Provides a Vital Link Between Fifth District Communities and Fed Officials

BY CHARLES GERENA

Get a bunch of people together over a hot meal and there's no telling what conversations will ensue. Who's the favorite to win the Super Bowl? Which Democratic presidential candidate might face President Bush in the 2004 general election? But when the directors of the Federal Reserve Bank of Richmond's board gather for dinner on Wednesday nights before their monthly meetings, it's a safe bet they'll be talking about one thing—the economy.

The men and women on the board look for ways to use their time together to “explore the important issues of the day,” says Wesley Williams Jr., chairman of the board and partner of the law firm Covington & Burling in Washington, D.C. They have discussed the economics of health care and other topics while dining on Virginia cuisine. “We

beyond the usual job description of a corporate board. In addition to overseeing operations, reviewing budgets, and setting priorities for their organizations, Reserve Bank directors represent the private sector's interests in the public formation of monetary policy. They accomplish this task through their discount rate recommendations and through their communications with Fed officials.

“As keen observers of local economies, the directors...contribute vitally to the formulation of monetary policy by offering important insights absent, by definition, from even the most careful analysis of aggregate data,” noted Alan Greenspan, chairman of the Federal Reserve Board of Governors, in a December 2000 speech. “Most importantly, this singular system of broad and diverse representation, nurtured by close contacts at the regional and local levels, fosters a long-term perspective and a continuity.”

Even though board members usually have long histories of working in a specific industry, they don't view themselves solely as industry spokespeople.

For example, Fred Green III, chairman, president and CEO of National Bank of South Carolina, didn't just represent community banks when he served on the Richmond Fed's board. Because he was the only director from the Palmetto State during the first two years of his three-year tenure, Green felt obliged to comment on statewide economic activities. “I talked to a wide variety of people in different industries, trying to get a feel for what the most current trends were,” says Green, who gave his fellow directors a book on



GEOP. SCHIMAN / FEDERAL RESERVE BANK OF RICHMOND

*The Federal Reserve Bank of Richmond held a joint meeting of the boards of its Richmond, Baltimore, and Charlotte offices in Washington, D.C., in October.*

had one [discussion] that was so heated that we ended up breaking it down into several sessions—it was called ‘What's really wrong with the economy?’ ”

As illustrated by the unique table talk of Richmond Fed directors, the board at each of the 12 Reserve Banks has a broad range of responsibilities

South Carolina history as background information.

During the roundtable discussion at every board meeting at the Richmond Fed, directors provide a bird's-eye view of the economy. They admit they do a lot of homework, knowing they have a unique opportunity to communicate with J. Alfred Broaddus Jr., president of the Richmond Fed, and staff economists.

For example, Joan Zimmerman, a member of the board of directors of the Bank's Charlotte office for five years, made use of her position as chief executive of Southern Shows Inc. The company regularly surveys businesses and consumers about their buying plans for the next six months. This enabled Zimmerman to cull reports on consumer intentions to make home improvements, buy houses, and purchase appliances.

For Craig Ruppert, president of Ruppert Companies, reporting on the economy was the most fun part of his six years on the Richmond Fed board. A few days before a board meeting, he would call five to 10 people from his network of businesspeople in and around his home base of Laytonsville, Md., to get a sense of how things were going. They represented a variety of industries, from manufacturing to construction and real estate. "They came to expect my calls [and] prepare for my calls," says Ruppert. Other directors also say they have conducted surveys.

Such information is subjective and informal, but it is nevertheless invaluable to board members and Fed policymakers. "What you get from the anecdotal information is, perhaps, an inkling of a trend...so that you can be ready if the numbers support it," explains Dyan Brasington, president of Technology Council of Maryland and a member of the board of directors of the Bank's Baltimore office since 2000.

It also provides fodder for the deliberations of the Federal Open Market Committee (FOMC), which sets interest rate policy. "Al Broaddus used to say the information that we bring is a major part of what he took to the FOMC," notes Zimmerman. (The FOMC con-

sists of the Board of Governors and five Reserve Bank presidents, four of which serve on a rotating basis.)

The exchange of information at board meetings isn't a one-way street. Board members hear Fed economists present information about the national and international economy. This gives them a macroeconomic perspective that they use in their day jobs.

"In this fast-paced, changing global economic environment, it is important for people in academia to have [an economic] perspective in planning for our institutions," says Lucy Reuben, provost and vice chancellor for academic affairs at North Carolina Central University. Since joining the Charlotte office board in 1999, Reuben has also used her directorship to inform the Research Triangle's business community about the intricacies of monetary policy. "We can take back a better understanding of the role of the Fed in the community."

**I**n addition to serving as a conduit of information, the board of directors has important supervisory duties. Breaking up into working committees (i.e. Audit, Executive Compensation, Building, Human Resources, etc.), directors review the Richmond Fed's budget, oversee internal audits, and provide guidance on a variety of Bank-wide issues.

Barry Fitzpatrick, CEO of Branch Banking and Trust Company of Virginia and a newcomer to the Richmond Fed board in 2003, is a member of the Audit Committee. The information he receives on the Richmond Fed's policies, procedures, and operations is broad. "When you leave that committee meeting, you have a good perspective of areas that need attention and [areas] that are doing well."

The board also appoints the president and first vice president of the Richmond Fed and all officers, subject to approval by the Board of Governors. Currently, directors are working with a search firm to find a replacement for Al Broaddus, who will retire this year after serving 11 years as the Richmond Fed's president.

Another highly visible duty of the board is recommending a level for the discount rate, the interest rate that the Fed charges for credit to banks. Broaddus suggests whether the rate should be raised, lowered, or kept the same. The directors discuss the proposal and vote on it, then their request is forwarded to the Board of Governors for final approval. The full board, during its monthly meeting, and an executive committee of directors alternately handle this task every two weeks.

The board of any Reserve Bank may request a change in the discount rate. However, past history indicates that a majority of boards usually must be on the same page before a change is made.

For example, the directors of Reserve Banks in Cleveland, Richmond, St. Louis, and Kansas City requested an increase in the discount rate seven times between June and August of 1999. According to meeting minutes, they were concerned about unsustainable growth, tight labor markets, and rising prices. But the directors on other boards weren't as worried about inflationary pressures and they didn't feel a rate increase was necessary. As a result, the Board of Governors didn't hike the discount rate until 10 out of 12 boards favored the action in late August 1999.

Obviously, directors don't always agree with Fed policymakers. But Tom Schlesinger, executive director of Financial Markets Center, a Virginia-based nonprofit that closely follows the Fed and the financial sector, believes that's a good thing. "The built-in tensions between a centralized element of the Fed—the Board of Governors—and the regional elements scattered around the country is very healthy."

Debate doesn't always lead to consensus, but it gives everyone a say in the decision-making process. "That's crucial because without the support [of different groups] the system would break down," notes J. Lawrence Broz, a political science professor at the University of California at San Diego who has written about the Fed's origins.

When lawmakers crafted the Federal Reserve System in 1913, ensuring that diverse interests were represented in policymaking was an important goal.

According to Broz, financial institutions feared that the central bank wouldn't pay attention to their perspectives. There also were concerns about having regional diversity in the Fed's management.

At the same time, people from the agricultural sector and other industries feared that bankers would be seated at the Fed's steering wheel. "People understood that the banks' interests wouldn't necessarily be the interests of all sectors," says Broz.

As a result, a board of directors, primarily selected by private interests in each region supervises the day-to-day operations of each Reserve Bank. Furthermore, the directors cannot be members of Congress or engage in partisan political activity.

To balance the independent perspective of businessmen and bankers on Reserve Bank boards, the Board of Governors sits above the banks and coordinates the nation's monetary policy. The seven members of the Board of Governors are nominated by the President and confirmed by the U.S. Senate.

Further, the nine directors on a Reserve Bank board are divided into three classes to provide some differentiation in their selection and representation. Three "Class A" directors are elected by and represent the interests of commercial banks which are members of that Reserve Bank, while three "Class B" directors are chosen by member banks to represent different parts of the regional economy. The remaining "Class C" directors are selected by the Board of Governors to represent regional interests as well, again striking a balance between political independence and public accountability.

The branch offices of Reserve Banks have their own boards as well, each with as many as seven directors. The Reserve Bank appoints the majority of these directors and the Board of Governors

appoints the remaining members. The branch boards don't have supervisory duties but they help relay information about local economies to Fed officials throughout the district.

Even though this structure is intended as a means for people across ideological and geographical boundaries to contribute to Fed policymaking, Broz argues that the people selected as Bank directors tend to be a relatively homogenous group. "[Since most of] the electing members are bankers, they are unlikely to appoint people to their governing body with interests that are very different from their own," he says.

In fact, a 1976 report by the Banking Committee of the U.S. House of Representatives found that banks and large corporations were disproportionately represented on Reserve Bank boards. So Congress required in the Federal Reserve Reform Act of 1977 that Class B and C directors be selected "with due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor, and consumers."

However, the legislation did not spell out how many directors should be named to represent each sector so imbalances in board representation still occur. "It's generally been true of all Reserve Banks that the interests and perspectives of labor, consumer, and community organizations have been underrepresented," says Tom Schlesinger.

This problem has improved in the past decade. Shifts in the economy have resulted in new business sectors rising to prominence on boards, while efforts by Reserve Bank presidents to encourage board diversity have had an impact. According to Schlesinger's organization, 12.8 percent of Class B and Class C directors who served between 1999 and 2002 were from the labor, consumer, or community sector, compared to 9.4 percent during the 1991-94 period.

A dramatic change occurred at the New York Fed's board, which was historically dominated by Fortune 500 executives. That board now includes two educators, an attorney, and the head of a nonprofit agency.

Wesley Williams has seen an improvement in board representation at the Richmond Fed during his seven years as a director. "I think there have been imbalances here and there, but they have been usually addressed fairly quickly," he says. "There was a time when...we had no labor representatives on the board. We now have a deputy chairman [Thomas Mackell] who has been intimately involved with a lot of the major labor organizations in the country." Williams credits Al Broaddus for keeping an eye on the board's diversity.

Each perspective has provided a well of expertise for the Richmond Fed to tap. Elleven Poston of Quality Transport, a South Carolina trucking company, provided information on fuel prices until her term on the Charlotte office board expired last December. The late Irwin Zazulia of Arlington, Va.-based Hecht's was a fountain of information about the retail sector at Richmond Fed board meetings.

Schlesinger concurs that the composition of Reserve Bank boards has gradually broadened. "There has been forward movement and some backsliding from Bank to Bank." But generally, "there is a good deal more diversity of perspectives on boards today." **RF**

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## Checks Enter the Electronic Age

BY JOHN R. WALTER

The majority of the 40 billion checks written each year in the United States must be returned in their original paper form in order for the bank to release the funds the check represents. This may soon change, though. The recently enacted Check Clearing for the 21st Century Act (Check 21) will remove legal impediments to electronic check collection, likely bringing with it a lower cost collection mechanism.

### Check Collection Under Current Law

When Susan Watson, who lives in Baltimore, Md., recently mailed a \$6,015 check to Arizona State University (ASU), in Tempe, Ariz., to pay her son's tuition bill, the original paper check was transported over 2,000 miles back to Ms. Watson's Baltimore bank. The process the Watson check followed is fairly typical for a check sent to a recipient in a distant location, and usually involves a series of steps.

For instance, ASU delivered the check to the Tempe branch of its Arizona-headquartered bank. Then the Arizona bank sent the check to the Los Angeles branch of the Federal Reserve Bank of San Francisco, which handles check collection for many Western states. The Fed then sent the check, along with several thousand others, back to Baltimore by air.

The original check was returned to the Baltimore bank (the "paying bank" in this example), which removed \$6,015 from Susan Watson's account and ordered it transferred to the Arizona bank. Specifically, the interbank movement of funds occurred over the books of the Federal Reserve. Following the instantaneous shift of funds on the books of the Federal Reserve, with which all banks hold balances, the Arizona bank credited \$6,015 to the account of the University.

### How Check 21 Will Change Check Collection

Check 21 will allow the "collecting bank" (the Arizona bank in this example) to "truncate" the check. Truncation occurs when an original paper check is stopped before being physically presented to the paying bank. The collecting bank scans the check, creating an electronic copy of the check, and then sends that electronic copy to the paying bank.

Since transporting electronic information over telephone lines or computer networks is far less expensive than delivering a physical piece of paper across the country, why aren't

banks already doing this for all checks? The reason is that under current law electronic means of collection can be used only if the collecting bank has a standing agreement with the paying bank to present checks electronically. Otherwise the paper check must be physically presented. Few standing agreements exist, so electronic collection is not widely used. (Any U.S. bank can expect to receive checks written on any other bank in the country. And since there are about 8,000 banks in the United States, uniform use of electronic presentment would require each bank to establish agreements with 8,000 other banks. In total, 64 million—8,000 x 8,000—agreements would need to be struck. This may be one reason why standing agreements are not commonplace.)

*"Over time, the current expensive system of delivering the original checks to paying banks may disappear."*

Check 21 will modify the agreement requirement. Beginning on October 28, 2004, paying banks no longer may demand the original check before making payment. Instead Check 21 specifies that as long as the collecting bank delivers a "substitute check," and that the substitute check meets certain size, legibility, and informational requirements, the paying bank must release funds, even though it has entered no prior agreement with the collecting bank.

A substitute check is also a piece of paper. But it is a scan of the original, not the original itself. So in our example, the Arizona bank might make an electronic copy of the original check when it first receives it from its customer, ASU. The Arizona bank then would transmit the electronic image over a computer network to Maryland. The electronic transmission could go directly to the paying bank in Maryland, if the paying bank were willing to accept electronic check information directly. Or the information from the scan could be sent to a substitute check printing facility near the paying bank. At that point, the paying bank would be required to release funds in return for the substitute check.

Check 21 specifies that substitute checks enjoy the same legal standing as original checks. So if a dispute arises between ASU and Susan Watson over whether the tuition bill was paid, Ms. Watson's production of the substitute check is proof of payment just as the original check would have been.

Check 21 should greatly lower check-processing costs. Over time, as banks and their customers adjust to the new law, greater use likely will be made of electronic check presentment and the current expensive system of delivering the original checks to paying banks may disappear. **RF**

## ECONOMIC SCORE DEBATED

### D.C. and Northern Virginia Vie for Baseball Team

Ahhh! The sound of baseball is in the air. Or at least there's talk of it in Washington, D.C., and the surrounding area.

Washington, D.C., and Northern Virginia are stepping up to the plate to bring major league baseball to their respective areas. But are there economic benefits to bringing a team to town? The debate usually centers around whether such stadiums boost a local economy,

“draw from a fan base in Northern Virginia and the rest of Virginia, which is out there ready to support a team without harming the Orioles. A major league team in D.C. would draw fans from the Baltimore-Washington corridor.”

In a 2000 George Mason University study, Stephen Fuller, professor of public policy, reported that “construction and operation of a \$300 million major league ballpark in Northern Virginia would have a substantial positive impact on the region's economy...” The study also said the park would have a ripple effect

originally calculated: an increase of 29.7 percent in total economic impact and 8.8 percent in total personal income generated.

The D.C. contingent sees things differently. Mayor Anthony Williams is proposing approximately \$339 million to build a stadium in the nation's capital. Says Harold Brazil, D.C. councilmember at large: “A baseball stadium will create hundreds of jobs for District residents and pump millions of dollars into our restaurants and stores—which means more tax dollars for city services and education.” A 1999 study conducted for the District estimated that a new baseball stadium would generate \$1.4 billion dollars in direct spending in the first 20 years.

“The current proposal for funding for the stadium is to come from a tax on players' salaries, taxes on goods sold at the stadium, and a new fee imposed on large businesses,” Brazil says. “There would be no diversion of current revenue for the stadium.”

Brazil also thinks that by placing the new baseball stadium downtown or on the waterfront, Washington can imitate the success of cities like Denver, Baltimore, and Cleveland. “By creating the incentive for ancillary development, these and other cities have generated millions of dollars in revenue for the government and private industry and thousands of jobs for their residents,” he says.



AP PHOTO

*Backers of public funding for a baseball stadium in Washington, D.C., point to the role that Camden Yards played in revitalizing Baltimore's Inner Harbor.*

Supporters in Northern Virginia argue that a stadium there would be a greater overall benefit than a similar stadium in D.C. because it wouldn't affect the Baltimore Orioles' fan base. Brian Hannigan, communications director of the Virginia Baseball Stadium Authority, says a stadium in Northern Virginia would

on the area's economy. According to the study, the project would add a total of \$100.4 million in new personal earnings and generate 3,384 new jobs in the Commonwealth during construction. A 2003 update reaffirms the earlier conclusions. It further indicates that the 30-year economic impact could be better than

Andrew Zimbalist, professor of economics at Smith College, disagrees. “You don’t build a public park because you think it’s going to raise potential income; you do it because it’s going to enrich the social and cultural life in the community. I think that on those grounds, to put public money into it, in the same way that you would put public money into building an art museum or a public park, is not an implausible proposition.” But as he points out in his book, *May the Best Team Win*, major league baseball’s monopoly status gives it leverage. “That leverage should not be the basis for any of these subsidies.”

Allen Sanderson, senior lecturer in economics at the University of Chicago, points out that stadiums bring minor economic benefit. “For every \$100,000 you spend, in my judgment, you’d get one full-time equivalent job,” he says. “Some people benefit—the sports fan, the owner of a nearby bar. But the subsidy has a negative ‘Robin Hood’ effect. Sports fans tend to be richer than average. It helps the players, owners, and fans. And the studies forget to subtract out leakages. The money spent doesn’t stay in the area: The T-shirts sold are not made [locally], the hotel money goes to the headquarters [in another city].”

Zimbalist and Sanderson say that when people choose a sports event, they forgo another entertainment, a “substitution effect.” Sander-

son says that when the Chicago Cubs made the playoffs, the event created extra business for some who were directly involved, such as sports writers and parking attendants. But attendance at malls, concerts, and other leisure activities dropped.

—ELAINE MANDALERIS

#### CLOSING OPEN DOORS

### Tighter Border Rules Slow the Flow of Foreigners

In global markets, moving people is just as important as moving goods. Overseas employees of American firms come to the United States for training, while foreign buyers meet with prospective suppliers here. In addition, travel and tourism is the nation’s largest services export. Yet tighter visa regulations have stifled the flow of people, contend both business and travel groups.

Since the Sept. 11, 2001, attacks on the World Trade Center and the Pentagon, consulates have assumed new responsibilities aimed at keeping terrorists off U.S. soil. For example, a greater number of people who request a visa to reach an American point of entry must be interviewed in person. Also, men between the ages of 16 and 45 must provide extra information to determine if an extensive background and security check is warranted.

Critics of the new standards acknowledge the importance of secure bor-



*Tourism to landmarks like the Smithsonian Institution has been affected by tighter visa regulations.*

ders, but they argue federal agencies aren’t equipped to do the job. For example, the U.S. Department of State says that most requests for security checks are processed in less than three weeks, but the FBI and other agencies have been receiving so many additional requests that there have been backlogs. Coupled with backlogs in conducting interviews and assessing high-risk applicants, this has resulted in months of delays for approving some visas.

A majority of foreign travelers aren’t subject to these delays, though. In 2002, 70 percent of America’s visitors, mostly from Western Europe, didn’t need a visa. But by October 2004, travelers from the 27 “visa waiver” nations will need a machine-readable passport. Moreover, all travel documents will have to contain a fingerprint or facial scan in addition to a photograph.

Many travelers have built in extra time for entering the United States. Still, visa applicants from certain countries like China and Russia have experienced lengthy delays. A sales executive from a West

Virginia manufacturing company recently told his horror story to a congressional committee. One of the company’s engineers in China was rejected twice for a visa on the grounds that he was an “immigration threat.”

No wonder some blame the new visa policies for the current decline in foreign visitation. After international arrivals peaked at 51 million in 2000, they dropped 12 percent in 2001 and 7 percent in 2002. A 4-percent drop is projected for 2003.

However, other factors could have prompted some foreigners to curtail their travel. “Because growth abroad has been relatively weak over the last two years, people don’t have the disposable income that they once had to travel,” surmises Jay Bryson, global economist at Wachovia Corp. Also, the dollar was strong compared to the Euro from 1999 to 2001.

In the Fifth District, many tourism markets haven’t been significantly affected by changes in foreign visitation because they depend on domestic

travel within or near the region. However, states with a significant presence of foreign operations have faced some difficulties.

“Ten percent of South Carolina’s work force works for an international company, the second highest percentage in the country,” notes Mark Condon, executive director of the South Carolina World Trade Center. “A lot of these companies have been suffering, but they have learned to plan further out for their international visitors.”

Bryson adds that tougher security measures post-Sept. 11 have probably discouraged only a few foreign firms from coming to America. “If there are good business reasons for someone to build a plant in South Carolina and have German nationals staff it, companies will continue to do that.”

—CHARLES GERENA

#### HEY Y’ALL

### The Disappearing Southerner

Ever since the end of the Civil War, writers have pronounced the South as dead as a deer strapped to a grill guard.

In a 2003 study, Larry J. Griffin and Ashley B. Thompson of Vanderbilt University in Nashville, Tenn., ask another question: “Enough About the Disappearing South, What About the Disappearing Southerner?” The purpose of the study is to better understand the pervasiveness of Southern identity.

The researchers use data from the University of North Carolina Southern Focus Poll, conducted between 1991 and 2001. Callers telephoned a random sample of people living in the South—defined as the 11 states of the Confederacy plus Kentucky and Oklahoma—and asked them if they considered themselves Southerners. Griffin and Thompson analyzed the results to study changes in the responses since the poll was first conducted in 1991.

The study estimates a 7.4 percent decline since 1991 in the proportion of people who called themselves Southern. This downward trend was evident across ethnic groups, income levels, and in both rural and urban locations. The researchers attribute this decline to the shrinking of “Southern identity’s core constituencies” and a diminished interest in being a Southerner. Overall, 70 percent of those polled said they were Southerners in 2001 (compared to 82 percent in 1991) prompting Griffin and Thompson to conclude:

“Self-defined Southerners are not a dying breed... But, proportionately, there are visibly fewer of them.”

According to the 2000 Census, just over five million people moved from the Northeast, the Midwest, and the West to the South between 1995 and 2000. This influx of non-Southerners could have contributed to the fall in Southern identity, researchers say.

The study also found that Southern identification is diminishing more slowly for African Americans than for white people. Griffin is proud of that, and says the South’s cultural, political, and economic changes have created a more comfortable environment for African Americans than existed before the Civil Rights movement.

John Shelton Reed, a sociologist at the University of North Carolina at Chapel Hill and the man who designed the Southern Focus Poll, says that being Southern “doesn’t mean what it did 100 years ago.”

Being Southern is nothing to be ashamed of, Griffin cautions. “If we lose our Southernness we may also forget some of those extraordinary accomplishments of the sixties and seventies,” he says, referring to the Civil Rights movement. “That would be sad indeed.”

—AMANDA WHITE GIBSON

#### THE BRAIN GAME

### South Carolina Invests Big Money in Research Facility

South Carolina is laying groundwork that may enhance the state’s reputation for research by bringing in top talent.

On a 400-acre campus near Greenville, Clemson University broke ground in November on the Clemson University International Center for Automotive Research. The center, set to open in 2005, aims to build on Clemson’s engineering expertise and support the state’s automotive manufacturing niche through a new graduate engineering center and research facilities.

The project currently is estimated at about \$90 million, some \$69 million of which will be paid for through state funds. However, the center also has generated private support, including \$15 million from BMW Manufacturing Corp. and its suppliers and \$1 million from IBM in products and services.

The state will pay for a \$15 million technology center



at the research facility, which BMW will lease from Clemson. State funding for that facility was part of a state incentive package when BMW announced a \$400-million expansion, worth 400 new jobs, in 2002.

The research center is an aggressive attempt to drive economic growth through nurturing human capital, according to Curtis Simon, associate professor at the John E. Walker Department of Economics at Clemson.

South Carolina, struggling financially like most states, has faced debilitating losses in the manufacturing sector during the past two decades. Even jobs in the state's high-tech automotive parts sector have declined, from 19,200 at the end of 2000 to 18,100 at the end of September 2003. This massive infusion of state money into the research center, it is hoped, will reverberate throughout the state in a positive way. The center will not depend solely on the automotive industry, Simon believes. The campus' location, along the Interstate 85 corridor between Charlotte, N.C., and Atlanta, Ga., is home to a cluster of automotive-related businesses.

"One would not be surprised that the research useful to BMW might be useful elsewhere," he comments. "So, for example, advances in materials, or if they study fuel efficiency—those kinds of things are going to find applications outside the industry." Though the center supports

the automotive industry, its intent is to draw tenants in need of technology and highly educated people.

It's critical to nourish "intellectual inputs," not just "material inputs," Simon notes. Firms outside the automotive industry that can use the research will locate in South Carolina to be near the center. "Am I thrilled about the prospect of using state money for it? I don't know... it might work and, if it does, well, my goodness."

—BETTY JOYCE NASH

#### REPORT RANKS CITIES

### Sunbelt Metro Areas Score Well

When you think of dynamic economic growth, Arkansas typically doesn't pop into your head. But a recent report from the California-based Milken Institute says the "Natural State" is home to the nation's best performing city: Fayetteville. The report analyzed the economic performance of the nation's 200 largest metro areas.

Two cities in the Fifth District made the top 20. Raleigh-Durham, N.C., came in at No. 12 and Washington, D.C., placed 19th. "For an economy with an IT hardware cluster, Raleigh-Durham's 12th ranking is extraordinary," write the report's authors Ross DeVol and Frank Fogelbach. Helping to stabilize Raleigh-Durham's economy in recent years were a contingent of life science firms and the area's major universities. Raleigh is also the

state capital and home to a large number of secure, well-paying government jobs.

Increased spending on homeland security boosted D.C.'s status, making it the strongest economy in its region. It even outpaced the southern Maryland and Northern Virginia suburbs.

The report's authors used a variety of components, such as job and wage growth, to rank cities. The rankings include a one-year score to provide a sense of the relative momentum of metropolitan economies. They also used a five-year score to smooth out business-cycle effects.

The rankings are exclusively outcome-based. For instance, they do not incorporate cost-of-living measures or quality-of-life factors. "All of these static measures are important, but can be highly subjective in nature. If a metro has a high quality of life, it should be reflected in its firms' ability to create jobs and attract human capital," DeVol and Fogelbach write.

Nineteen of the top 20 metro areas are located in the South or West. Only one—Monmouth-Ocean, N.J.—is from the Northeast or Midwest. Seven of the top 20 metro areas were in California.

Getting back to Arkansas, why does Fayetteville score so well? The answer almost can be summed up in one name: Wal-Mart. The recession caused Americans to shift spending to discounters and away from upscale retailers, a trend that Wal-Mart

### Economic Excellence

The following cities ranked highest in an analysis of economic performance among the nation's 200 largest metropolitan areas.

1. Fayetteville, Ark.
2. Las Vegas, Nev.
3. Fort Myers, Fla.
4. West Palm Beach, Fla.
5. San Diego, Calif.
6. San Luis Obispo, Calif.
7. Laredo, Texas
8. Brownsville, Texas
9. McAllen, Texas
10. Monmouth, N.J.
12. Raleigh-Durham, N.C.
19. Washington, D.C.

SOURCE: Milken Institute

capitalized on, while competitors such as Kmart faltered. Wal-Mart also has attracted a "wide agglomeration of suppliers, partner firms, and IT intensive logistic firms such as J.B. Hunt," write DeVol and Fogelbach. In addition, Fayetteville is home to the main campus of the growing University of Arkansas and poultry processor Tyson Foods Inc. "Despite a greater-than-average concentration of manufacturing there, it has a low dependence on durable goods, which aided its performance during the recent recession," the report's authors write.

The full text of the report, titled "Best Performing Cities: Where America's Jobs Are Created," can be found on the Milken Institute's Web site at [www.milkeninstitute.org](http://www.milkeninstitute.org).

—AARON STEELMAN

## Jobless Recovery

BY AARON STEELMAN

As recessions go, the most recent downturn was relatively mild. According to the National Bureau of Economic Research, it lasted just eight months—from March to November 2001—and during that time real gross domestic product (GDP) declined only modestly before picking up again. Indeed, there are signs that the economy is gaining steam: Preliminary data show that real GDP grew 8.2 percent in the third quarter of 2003. But there remains a dark cloud in this otherwise hopeful picture: the labor market. Employment growth has been unusually weak following the recession, leading some to dub this a “jobless recovery.”

According to the payroll survey conducted by the Bureau of Labor Statistics (BLS), the U.S. economy has lost 2.8 million jobs since the recession began. Roughly 2.4 million of those losses have been in the manufacturing sector. The BLS conducts another employment survey, the household survey, which shows less severe losses. By that measure, 1.3 million jobs were lost during the recession, but more than 600,000 jobs have been added since.

Why the difference? The payroll survey asks companies how many employees they have, while the household survey asks people whether they have jobs. As a result, the household survey captures many single-person proprietorships that are left out of the payroll survey. And in a slow economy this can be particularly important. For instance, people who lose their jobs often find it desirable to work as consultants or independent contractors until more permanent positions become available.

Also, some observers have suggested that the household survey is more effective at accounting for newly created jobs at start-up companies. “In our dynamic economy, old firms die and new ones are born. The [BLS] learns about the deaths quickly, but it takes longer to learn about the births,” argues Allan Meltzer, an economist at Carnegie Mellon University. This, no doubt, was true for past recoveries. But recent revisions to the payroll survey have likely improved its coverage of new businesses.

Overall, economists tend to prefer the payroll survey to the household survey. Its primary advantage lies in its larger sample size. The data in the payroll survey come from about 400,000 businesses, covering roughly a third of total nonfarm employment. In contrast, the household survey is

based on data collected from about 60,000 households.

“Whatever the verdict regarding the relative reliability of the two surveys, their differences should not obscure the fact that the U.S. labor market has been weak,” stated Ben Bernanke, a member of the Federal Reserve Board of Governors, in a November 2003 speech.

One factor contributing to recent labor-market weakness is common to almost all recoveries. Businesses are typically hesitant to hire new workers until they are sure the downturn is over because they don’t want to be burdened with excess labor costs should the recovery prove fleeting. It’s not unusual, for instance, to see a few quarters of GDP growth before some employers decide to increase their work force.

But this alone cannot account for the type of employment weakness we have seen recently. Consider a few other possibilities.

First, some have argued that increased benefits costs—especially health insurance costs—are deterring employers from taking on new workers. For instance, benefits costs rose more than 11 percent from September 2001 to September 2003, while wages and salaries grew at just 6 percent.

Second, political uncertainty may be playing a role. The terrorist attacks of Sept. 11, 2001, and the war in Iraq have made some employers hesitant to expand their operations.

Third, structural changes in the economy could be important. In particular, many of the manufacturing jobs that were lost during the recession may be gone for good. Employers saw the recession “not as an event to be weathered but as an opportunity—or even a mandate—to reorganize production permanently, close less efficient facilities, and cull staff,” write economists Erica Groshen and Simon Potter of the Federal Reserve Bank of New York.

Fourth, productivity growth continues to be strong at around 4.5 percent per year, compared to a historical average of roughly 2.5 percent. In many ways, this is a huge boon to the economy. Over time, productivity growth boosts real incomes and leads to more efficient industries. But it also can mean that employers need less labor in the short run.

While there is no single explanation for the jobless recovery, increased productivity is quantitatively “probably the most important” factor, Bernanke concludes. **RF**



ILLUSTRATION BY TIMOTHY COOK

## Faith and Economics

BY AARON STEELMAN

Why do some economies grow while others remain stagnant? That is perhaps the largest—and most important—question in all of economics. Indeed, Adam Smith, who is generally credited as the founder of classical economics, titled his most famous work *An Inquiry into the Nature and Causes of the Wealth of Nations*.

Modern growth theorists have examined a number of cases from around the globe: the strong growth of the “East Asian Tigers”—Hong Kong, Singapore, South Korea, and Taiwan—from the 1960s through the early 1990s; the struggles of the import-substitution economies of Latin America during the 1970s and 1980s; and the failure of sub-Saharan Africa’s planned economies following independence.

Harvard University economist Robert Barro has been at the forefront of cross-country empirical studies of economic growth. His work has highlighted the importance of institutions—in particular, the crucial role that the rule of law plays in economic growth. Countries that protect property rights, recognize the sanctity of contracts, and resolve disputes impartially tend to enjoy relatively strong economic performance. In contrast, those countries that suffer from political corruption and government expropriation of property tend to struggle.

Closely related to the rule of law is the role of democratic government. To the extent that democracy works as a check on state intervention, it can be a positive influence on economic growth. But countries with already moderate levels of democracy often do not grow quickly. One possible explanation is that further democratization may generate support for social-welfare programs and income redistribution, which can retard growth. “[M]ore democracy raises growth when political freedoms are weak but depresses growth when a moderate amount of freedom is already established. One cannot conclude from this evidence that more or less democracy is a critical element for economic growth,” argues Barro in his 1997 book *Determinants of Economic Growth*.

More critical than democracy itself is the type of public policies that democratic and nondemocratic governments pursue. For instance, widespread schooling at the secondary level and above often boosts human capital and with it economic growth. Stable monetary policy that keeps inflation low is important also. But high levels of government consumption (measured exclusive of education and defense) can be a drag on the economy, as resources are diverted from the private sector.

What’s missing from this equation? Some would argue culture. Sure, institutions and public policies are important but the fundamental beliefs of a society will also influence economic performance. For instance, early in the 20th century the eminent sociologist Max Weber argued that the “Protestant ethic” bolstered economic growth by providing religious sanctions that fostered personal discipline, hard work, and the acquisition of wealth. This process, Weber argued, was particularly true in areas where Calvinism was dominant.

In a recent article, Barro and his Harvard colleague Rachel McCleary have looked at the role religion plays in economic growth. They envision “a chain whereby church attendance affects religious beliefs, which affect individual traits, which affect individual and aggregate economic outcomes.” In other words, their hypothesis is quite Weberian: Religion may encourage such traits as honesty, diligence, thrift, and openness to others, which, in turn, may affect economic performance.

They test this hypothesis on a sample of 59 countries that vary widely in levels of economic development, political freedom, and religious belief. The results largely confirm their hypothesis. Increases in certain “religious beliefs—notably belief in hell, heaven, and an after-life—tend to increase economic growth. There is some indication that the fear of hell is more potent for economic growth than is the

prospect of heaven,” they write.

But this does not necessarily mean that churchgoing is critical to the process. In fact, insofar as those virtuous beliefs can be inculcated in people without organized religion, then higher levels of church attendance actually may depress economic growth. The reason is that “greater attendance signifies a larger use of resources by the religion sector”—resources that otherwise could have been used toward commercial activities. The net effect “depends on the extent to which an increase in attendance leads to stronger beliefs,” conclude Barro and McCleary.

What does all this tell us? That the process of economic growth is complicated and not fully understood. Economists have been right to focus closely on the role that institutions and public policies play. Yet, at the same time, they ought not ignore the seemingly vague and imprecise issue of culture.

Sociologists have been urging economists to give greater consideration to cultural issues for decades. It will be interesting to see how they greet Barro and McCleary’s findings. **RF**

“Religion and Economic Growth Across Countries” by Robert J. Barro and Rachel M. McCleary. *American Sociological Review*, October 2003, vol. 68, no. 5, pp. 760–781.

*The globalization of manufacturing has produced cheaper goods for everyone,  
but the trend has cost hundreds of thousands of jobs in the Fifth District*

# GLOBAL GAIN LOCAL PAIN

BY KARL RHODES

**W**illie Robinson worked at the textile mill in Newton, N.C., for 28 years. Most recently, she drove a forklift, and before that she operated several different machines that turned cotton into yarn. In the mid-1990s, Robinson was working six or seven days a week, but by late 1999, the plant began to slow down.

“In 2001, it really started getting slack,” she recalls. “We started hearing rumors. Then, the first of April, they had a large layoff. ...They told us then, point-blank, that within three months our plant would be closing.”

The plant was owned by Pillowtex Corp., a large textile company based in Kannapolis, N.C. Two years after Robinson lost her job, the company closed nearly all of its operations and

filed for Chapter 11 bankruptcy. More than 7,600 people lost their jobs that day, including 4,800 in North Carolina.

It was the largest single layoff in the state’s history, but Pillowtex is just one example. Manufacturing employment in the Fifth District declined 16.9 percent from 1993 to 2002, more than double the 7.5 percent decrease that the entire United States experienced during those years. And while manufacturing employment in the rest of the nation has shown some signs of stabilizing, manufacturing employment in the Fifth District remains weak.

The region’s top two manufacturing sectors—textiles and apparel—have struggled to compete against cheaper foreign imports, particularly from China and other developing nations.

The rest of the United States has the same problem, but textile and apparel manufacturing is highly concentrated in the Fifth District. In 1993, these two industries accounted for more than 23 percent of all manufacturing jobs in the Fifth District, while nationwide they accounted for just 9.2 percent of manufacturing jobs. By 2002, those percentages had fallen to 14.1 percent in the Fifth District and 5.7 percent in the United States. Nationwide, more jobs have been lost in textiles and apparel than in any other seven manufacturing industries *combined*.

Meanwhile, nearly everyone in the United States has benefited from the globalization of manufacturing. It has provided cheaper products to American consumers, and it has freed up



resources for the creation of entire new industries. But globalization also has eliminated hundreds of thousands of jobs in the Fifth District, particularly in the Carolinas and Southside Virginia. The economic pain has been highly focused on small towns where one or two textile plants were the primary employers. Many people in those towns have lost their livelihoods, and they face futures overflowing with uncertainty.

"The last day [at Pillowtex] is when I think it really hit," Robinson recalls. "I think we all cried together that day. ...I knew that I wouldn't be getting up every morning and getting ready to go to work. ...It was like, 'Well, God, what am I going to do with my time now? Where will I find another job?'"

**M**anufacturing in the Fifth District goes all the way back to Jamestown, but the Civil War severely stunted its development. Following Reconstruction, most of the growth occurred in resource-processing industries such as food, lumber, and wood products. This was primarily a resumption of Southern manufacturing that had occurred before the Civil War, but it soon was supplemented by growing production of textiles, apparel, and cigarettes.

These industries continued to grow rapidly in the Fifth District during the early and mid-20th century, along with furniture making and chemical manufacturing. Attracted by lower wages, lower overheads, lower taxes, and weaker unions, manufacturers from the Northeast and Midwest migrated south

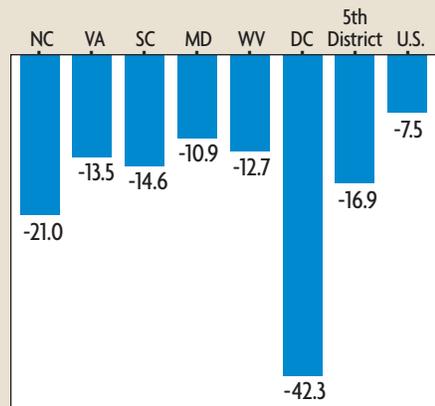
in the 1960s and 1970s, bringing a wider variety of labor-intensive industries to the Fifth District.

By the mid-1980s, some of these companies—including many of the textile and apparel manufacturers—began moving production capacity to other countries. And in the 1990s, concerns about the North American Free Trade Agreement were trumped by growing competition from Asian nations, most notably China. Waves of low-cost, high-quality imports have forced many manufacturers to close factories in the Fifth District. Others have upgraded their equipment to require less labor, consolidated their operations, or focused on producing niche products.

Many Americans blame the job

## Manufacturing Employment Falling Fast

Percent change from 1993 to 2002



SOURCE: U.S. Bureau of Labor Statistics

losses entirely on foreign trade, but higher productivity and lower demand are major factors as well, says Phillip J. Kirk Jr., president of the North Carolina Citizens for Business & Industry.

"I'll tour plants and there'll be expensive machinery in there, and I'll ask, 'How many people does it take to operate that?' And they'll say, 'One or two.' And it took the place of 40 to 50 workers," Kirk says. "Companies had to automate to become more efficient to keep from closing down entirely. ... Then, with the recession, people are just buying less."

In the past 10 years, the most dramatic job losses have been in textiles and apparel, but Fifth District employment is down in the vast majority of its manufacturing industries. The six exceptions are computers, fabricated metals, wood products, plastics, food, and transportation equipment (see automotive sidebar on page 17).

States in the Fifth District do not break down manufacturing employment numbers for every industry, so precise job counts are not available in each industry, but broad trends are clearly visible. In Virginia and North Carolina, for example, furniture-making jobs are down 18.8 percent, while in West Virginia, South Carolina, and North Carolina, chemical-manufacturing jobs are down 13.5 percent. Machinery manufacturing jobs also are down 14.4 percent in North Carolina, South Car-

olina, and Maryland. Employment in primary metals and tobacco is down significantly on a percentage basis, but these industries aren't nearly as large as those listed above.

"If there are people out there saying, 'Hey, that's a textile-only problem,' they're wrong," says Lewis Gossett, president of the South Carolina Manufacturers Alliance. A prime example, he says, is KEMET Corp., a large manufacturer of capacitors based in Greenville, S.C. Capacitors are electronic components that accumulate and hold electrical charges. They fall into the manufacturing category of electrical equipment and components, which is down 13.3 percent in South Carolina and North Carolina in the past 10 years.

In mid-2001, KEMET cut its U.S. work force by 675 and its Mexican work force by 1,130. "In my 42 years in this industry, the rapidity and depth of the current correction is unprecedented," said CEO David E. Maguire. More layoffs followed in December 2001, and another round hit in July 2002.

As the market for capacitors began to recover, KEMET prepared to manufacture them overseas. In January 2003, the company reported plans to open a plant in China by the end of the year, while it announced more work force reductions in South Carolina.

"It's almost like the reports from Iraq, where you hear about a soldier or two being killed each day," Gossett agonizes. "You pick up a newspaper and you read about a facility closing. ... The problem with these textile mill closings in particular is that oftentimes they are the mainstay of that community's economy. ... When you take that tax base out of the community, a number of other things die with it."

Globalization makes strange bedfellows. American manufacturing executives and union leaders both blame U.S. trade policies for the loss of American manufacturing jobs. On the day Pillowtex declared bankruptcy, Bruce Raynor, president of the Union of Needletrades, Industrial, and Textile Employees (UNITE) issued the following statement: "The responsibility for this

tragedy lies squarely at the feet of government officials in Washington, in both Democratic and Republican administrations, who have created trade policies that are destroying the textile industry and manufacturing as a whole throughout America. Those elected officials who have supported FAST TRACK, NAFTA, and permanent normal trade relations with China have placed American workers and U.S. companies in an impossible position of competing with poverty wages and sweatshop conditions."

Russell Roberts, professor of economics at George Mason University, agrees that U.S. manufacturers are more regulated than their global competitors, but he's not ready to pull the plug on safety codes, pollution limits, or child labor laws. "Most of those standards...are good things for our people," he says. "The Chinese people can't afford most of them. ... That makes it harder in some areas for American manufacturers to compete, but most Americans would say that's OK: Americans shouldn't be doing those jobs in those particular ways."

Eventually, economists expect the employment pendulum to swing in a different direction. As China becomes more prosperous, its manufacturers will have to pay higher wages and provide better working conditions, and their primary competitive advantage will be gone or significantly diminished.

"China has been the recipient of a great many manufacturing jobs over a great many years," says Ray Owens, a vice president and senior economist at the Federal Reserve Bank of Richmond. "But at some point that will change, and the people in China will be complaining about the loss of manufacturing jobs to some new hot spot."

Gossett agrees with that prediction in the long run, but he worries about what will happen to U.S. manufacturers in the meantime. "I'm not sure that a couple of generations worth of losses just to see the [invisible] hand work things out eventually is worth it," he says.

But one recent study suggests that it may not take that long. Economists at Alliance Capital Management L.P. studied manufacturing employment in the world's 20 largest economies, and

they concluded that China lost manufacturing jobs faster than the United States from 1995 to 2002.

“Contrary to popular belief, the global push to relocate facilities to countries with lower production costs has not caused an increase in manufacturing employment in those areas,” wrote Joseph Carson, a senior vice president in Alliance’s global economic research department. “In fact, since 1995, the reduction of manufacturing jobs in China has been as large as that of any other country.” Carson concluded that the primary reason for the loss of manufacturing jobs worldwide is increases in productivity — not globalization.

**M**any American manufacturers embrace the global economy, but they say that “free trade” doesn’t necessarily mean “fair trade.” “We have trouble taking a protectionist position as an association because many of our companies source components or manufacture completely in Asia,” says Brett Vassey, president of the Virginia Manufacturers Association. “It would be short-sighted to...close our borders and throw up all the tariffs. ...But we do have an underlying sentiment, even among our multinational members, that there’s a difference between free trade and fair trade.”

Economists typically don’t think much of that distinction, though. When people call for “fair trade,” usually what they’re really after is special protection of their industry.

“Let’s suppose that China is pursuing a deliberate strategy to underprice its exports,” says Roberts, the economist at George Mason. “My first thought is: Great! Cheap goods for us! I understand that leads to challenges for people in those industries, but for Americans overall, the real issue is: Will that lead to some future where we’re suckered into losing all of our textile and apparel [manufacturing capacity] and then the Chinese can take advantage of us by jacking up prices later? I don’t know of any historical examples of where that has happened in international trade.”

Americans also accused the Japanese of cheating in the 1980s, Roberts

remembers. “They said, ‘Japan cheats. They’re keeping out our industries. They’re not importing anything from us. They’re building up expertise in industries that we’re good at. They’re going to destroy those industries, and we are going to be at their mercy.’ That [conspiracy theory] was wrong. One: They didn’t destroy our industries, although they did take a bite out of a bunch of them. And two: The net result for Americans was higher-quality, lower-cost goods and innovation on the part of American firms now in a more competitive marketplace. ...That’s probably what’s going [to happen] with China.”

Still, there is strong sentiment among manufacturing officials that China and other countries just aren’t playing by the rules.

In a September speech to the Detroit Economic Club, U.S. Commerce Secretary Don Evans acknowledged that China has not kept some of the promises it made when it joined the World Trade Organization in 2001.

“China agreed to let nonbank entities establish financing arms so their consumers could purchase automobiles. We’re still waiting. They also promised free access to established distribution systems for American goods. We’re still waiting. But we won’t wait idly. We will work to ensure that China honors the commitments it makes.”

China, for example, agreed to limit its exports of certain types of apparel to the United States, says Gossett of the South Carolina Manufacturers Alliance. But China has not kept that promise, and the result has been devastating to apparel manufacturers in the Fifth District. “As I understand it, those safeguards were put in place in return for a number of industries dropping their opposition, or at least tempering their opposition, to China’s entry into the WTO,” Gossett says. “If those safeguards are not enforced...it really diminishes the amount of trust that American industry has for these trade agreements.”

### Fifth District Manufacturing Jobs By Industry (Jobs in Thousands)

Industry	1993	2002	% Change	States Reporting Data <sup>a</sup>
Apparel	120.6	40.1	-66.7	NC, SC
Textile Mills	255.4	141.8	-44.5	NC, SC, VA
Textile Product Mills	40.4	27.6	-31.7	NC, SC
Primary Metals <sup>b</sup>	27.1	21.3	-21.4	MD, SC, WV
Furniture	107.7	87.5	-18.8	NC, VA
Beverage & Tobacco Products	22.3	18.2	-18.4	NC
Chemicals	111.5	96.5	-13.5	MD, NC, SC, WV
Machinery	77.3	66.2	-14.4	MD, NC, SC
Electrical Equipment	48.3	41.9	-13.3	NC, SC
Nonmetallic Mineral Products	27.7	24.4	-11.9	NC, WV
Paper	30.3	26.8	-11.6	MD, NC
Printing	34.7	32.0	-7.8	MD, NC
Computer & Electronic Products	78.9	82.5	4.6	MD, NC, SC
Wood Products	33.7	35.4	5.0	NC, WV
Food	87.1	91.5	5.1	MD, NC, SC, WV
Plastics & Rubber	67.9	72.5	6.8	MD, NC, SC, WV
Transportation Equipment	106.6	116.1	8.9	MD, NC, SC, VA, WV
Fabricated Metal Products	66.9	74.1	10.8	NC, SC, WV

<sup>a</sup>States in the Fifth District do not break down manufacturing employment numbers for every industry, so precise job counts are not available. The numbers in this table are compiled from the states listed that report separate employment numbers for these industries.

<sup>b</sup>Some of the job loss in primary metals has occurred in the northernmost portion of West Virginia, which is not part of the Fifth District.

SOURCE: U.S. Bureau of Labor Statistics (Annual Averages)

Gossett concedes, however, that the United States is bargaining from a weak position because of nuclear proliferation in North Korea. "This administration is in a tough position right now," Gossett says. "How much pressure can the Bush Administration put on the Chinese when the Bush Administration needs the Chinese for influence on the Korean Peninsula? The Chinese are such a significant player there, and nothing they do is unrelated. So I can imagine that trade policies come up in those [disarmament] discussions." (*At presstime, the Bush Administration announced plans to impose temporary quotas against select textile products from China, including bras, bathrobes, and knit fabrics.*)

Another item that comes up in discussions with China is currency manipulation. China deliberately undervalues its currency to gain unfair competitive advantages, according to William Primosch, director of international business policy for the National Association of Manufacturers. Testifying before the Congressional-Executive Commission on China, Primosch said: "Economists have estimated that China's currency could be undervalued by 40 percent or more. The Chinese yuan has remained pegged to the dollar at 8.28 [yuan per dollar] for the past

eight years despite an extended period of robust economic growth."

Prompted by numerous complaints about China, the Bush Administration has been talking tough. U.S. Treasury Secretary John Snow recently told Chinese leaders face-to-face that currency values should be determined by free-market forces. And Evans has pledged that the Bush Administration will aggressively target unfair trade practices, including dumping, counterfeiting and piracy of intellectual property.

"American manufacturers can compete against any country's white collars and blue collars," Evans said. "But we will not submit to competing against another country's choke collars."

Many economists, however, say that type of rhetoric is unwarranted. "I see no evidence that China has cheated or is not living up to its obligations under the World Trade Organization," says Douglas A. Irwin, professor of economics at Dartmouth College. Still, Irwin understands the desire to block goods from coming in from abroad. "Whenever we're in a recession and whenever our firms are facing import competition, they are going to complain because they are hurting. ...So I don't blame them for trying to stop imports."

In a recent paper, Dan Ikenson, a policy analyst at the Cato Institute's Center for Trade Policy Studies, notes that U.S. textile and apparel manufacturers have enjoyed "decades of protectionist exceptions." Most of that protection will evaporate on Jan. 1, 2005, when the WTO's Agreement on Textiles and Clothing comes to a close. But "getting to this point has been difficult," Ikenson writes. "The United States is widely perceived to have obstructed implementation of an agreement that was intended to achieve incremental liberalization in four stages over 10 years. To this day, most products that were to be liberated from quotas remain under quantitative restrictions."

Owens, the economist at the Federal Reserve Bank of Richmond, also warns against China bashing. He points out that much of the manufacturing capacity in China is owned or controlled by U.S. companies. "The capital is coming from us," he says. "We

are the people who are putting production capacity in China. It's popular to blame 'them.' It's not popular to admit that 'they' are 'we.'"

The impact of multinational free trade boils down to global gain versus personal pain, according to Roberts. The macro question is: What's the impact on the U.S. economy in the long run? The micro issue is: What's the impact on people who are losing jobs right now?

"It's very tough on the people in those industries who have very narrow skill sets or very low skill sets," Roberts concedes. "Their opportunities to find alternatives are very limited. They also have typically low education levels. ...For the rest of us, it's good news. It means lower prices for the textiles and apparel that we wear."

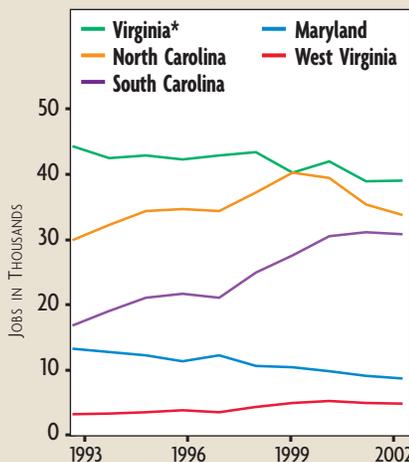
Roberts also notes that the decline of America's textile industry frees up resources to produce other goods and provide new services. "Industries have been started because we have been able to be more productive in the manufacturing area," Roberts says. "We've been more productive in two ways: We are more productive in the obvious sense that the amount of resources it takes to produce a particular amount of manufactured goods has gone down, and we are also importing more goods from overseas, which is just another way of being more productive."

Both of these trends have significantly reduced the demand for manufacturing manpower in the United States and in the Fifth District. But manufacturing output continues to rise, even as manufacturing employment continues to fall. That trend is at least 50 years old, Roberts says, and it mirrors America's transformation from an agrarian economy to an industrial economy in the preceding 50 years.

"In 1900, 40 percent of the U.S. economy was in agriculture. Today it's about 2 percent," Roberts says. "That was a very challenging transition for lots of farmers who saw that their farms were no longer productive because larger farms and technology were crowding them out. ...A lot of people lost their farms and had to suddenly

## Built to Last

Transportation equipment jobs steady the manufacturing sector



\*Nearly all of Virginia's decline in transportation equipment manufacturing jobs has occurred in shipbuilding employment, which fell from 27,200 in 1993 to 20,200 in 2002.

NOTE: Annual averages in thousands

SOURCE: U.S. Bureau of Labor Statistics

## From Model Ts to Z4s

### Auto Manufacturing Accelerates in the Fifth District

While other manufacturing industries have cut their work forces in the Fifth District, the automotive segment has created thousands of new jobs in the past 10 years.

Employment in the transportation equipment category increased 8.9 percent in the Fifth District from 1993 to 2002, and the automotive portion of that category has grown even faster. Not every state in the Fifth District breaks out employment numbers for the automotive industry, but a closer approximation of automotive manufacturing jobs can be achieved by subtracting Virginia's substantial shipbuilding employment from the Fifth District's total for transportation equipment. The remaining transportation equipment jobs—mostly automotive—jumped 20.8 percent in the Fifth District from 1993 to 2002.

The biggest single driver of that growth has been BMW's North American manufacturing facility in Spartanburg County, S.C. The company broke ground for the plant in 1993, and it has expanded the facility several times to produce new models, including the X5 sport-utility vehicle and the Z4 roadster.

As of May 2002, BMW had invested \$1.9 billion in the plant, according to a study commissioned by BMW and conducted by the Moore School of Business at the University of South Carolina. The plant, which employs more than 4,300 people, generates \$27.6 million in state and local tax revenues each year after accounting for incremental growth costs incurred by state and local governments.

Those governments provided \$130 million in long-term incentives to attract BMW to Spartanburg County in 1992. "Undeniably, the BMW location decision represented a major achievement in South Carolina's promotion of economic development," the study concluded. "In an area that has witnessed steady job losses in the traditional nondurable goods (textiles and apparel) sector, BMW adds thousands of high-wage, high-value-added, high-skill jobs."

If BMW wins the automotive Oscar for best performance in the past 10 years, then the Ford plant in Norfolk, Va., gets the lifetime achievement award. The plant started making Model Ts in 1925, and its 2,400 workers now produce the popular F-150 pickup truck.

"Although the Ford plant in Norfolk is one of the oldest plants in the Ford system, Ford has always favored it because they claim they have better production there than they do just about anywhere else," says William F. Mezger, an economist with the Virginia Employment Commission. "They tend to keep the Norfolk plant going when they are shutting down other things."

The Ford plant has been the stabilizer of Virginia's auto industry, but most of the recent growth has come from smaller plants that make parts for a variety of vehicles. "Because



*The presence of BMW in Spartanburg has provided a boost to the South Carolina economy.*

the auto industry contracts out for components now, a lot of firms set up in Virginia because it is a right-to-work state," Mezger says. "I understand that some of those components are shipped to Mexico for vehicles that are assembled in Mexico and then shipped back to the United States."

West Virginia's automotive manufacturing surge also has an international nature. In 1996, Toyota Motor Manufacturing announced plans to build four-cylinder engines in Buffalo, W.Va. And in January 1998, the company unveiled plans to expand the facility to produce six-cylinder engines, too. Three years later, Toyota announced plans to expand the complex again to build engines and transmissions for the Lexus RX300 sport-utility vehicle. This most recent expansion has pushed the company's investment in the plant up to \$950 million. It currently employs about 1,000 people.

Last year, in recognition of the plant's contributions to the state's economy, Gov. Bob Wise named its former top executive, Tomoya Toriumi, an honorary West Virginian.

—KARL RHODES

change their lifestyle from a rural to an urban lifestyle. ...That was hard on a lot of people, but it was glorious for Americans who eat, which is all of us."

Dramatic increases in productivity generated abundant supplies of food at lower prices, Roberts concludes. "The result was land freed up to do other things. The result was all kinds of resources and people freed up to create new jobs and new industries that wouldn't have existed otherwise. There was some hardship, but most of us would say that hardship was a price worth paying."

"I think the economists who talk that way are employed," snorts Kirk at

the North Carolina Citizens for Business & Industry. "They're not drawing unemployment compensation. I think we need to be concerned about any job losses ... and try to prevent them from happening. We also need to look at some new kinds of jobs."

On that point, Kirk and Roberts can agree. "What we really want to do for those folks is to give them the opportunity to get the skills they need to be more successful in a global marketplace," Roberts says.

Willie Robinson, the worker who lost her job at Pillowtex, is a good example. She earned her general education diploma in 1988, and she enrolled

in Catawba Valley Community College when the Pillowtex plant closed.

"Toward the very end...we did assessment tests and placement tests," Robinson recalls. "Some of the placement tests that I had taken said I could be an airline pilot, which I chose not to be," she chuckles.

Instead, Robinson decided to study health-care technology management, a two-year degree program that she enrolled in with two friends from her years at Pillowtex. They call themselves "the three amigos."

"We haven't separated the whole time that we've been going to the school," she says. "If one is in need, the

other two will help out. ... That's what I call a true, true friend because we've stuck together through the worst times."

Former Pillowtex workers see lots of familiar faces at North Carolina's community colleges. Within six weeks of the company's closing, more than one-fifth of its displaced workers were enrolled in the state's community college system, which has been scrambling to respond to a four-year surge in demand. Overall enrollment is up nearly 10 percent since 1999. The colleges' parking lots are overflowing. Retired teachers and other employees are coming back to help, while high schools and community centers are providing makeshift classroom space.

The intense demand for retraining has challenged the community colleges, but it has been even harder for the new students. The average age of former Pillowtex employees is 46.3, says Stephanie



*The three amigos (left to right) are Allison Abernathy, Willie Robinson, and Julie Killian. After losing their jobs at Pillowtex, they hit the books at their community college.*

One of the things that makes America strong is its industrial base, says Gossett at the South Carolina Manufacturing Alliance. "It was our salvation 60 years ago, and it has been the thing that has propelled us to the prosperity that we enjoy today. If we stop making things in this country, we are sapping part of our strength."

At the Virginia Manufacturers Association, Vassey agrees, but he argues that all manufacturing jobs are not created equal. Economic developers, he says, should do everything they can to attract and retain technology-intensive manufacturers that pay higher wages.

Perhaps the United States should do nothing to retain industries that chase cheap labor, Vassey suggests. "It was Mexico. Now it's China. It could be India. It could be North Africa. ... This isn't going to stop. It's just going to go from one developing country to another."

But Vassey and Gossett both say that the United States must not abandon its manufacturing sector. "Something has to support service industry. Something has to form the foundation that provides those people with an opportunity to make a living and prosper," Gossett says. "Somebody at some point needs to be making something."

That "somebody," however, will no longer be Willie Robinson. She is sticking with her plan to enter the health-care industry. "I felt like textiles were going to go out because there were so many places around here that had closed," she says. "I was trying to look more toward the future and something permanent that I know is going to be

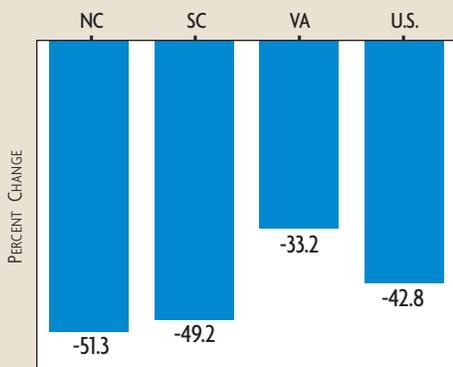
here regardless. There is always going to be somebody sick."

Several new health-care facilities have opened recently near Robinson's home, and she is optimistic that her new skills will command higher compensation than the \$9 an hour she was earning at Pillowtex.

Robinson is making good grades at the community college, but she has one more semester to go and her unemployment benefits are nearly exhausted. After that, she's not sure how she will pay her bills, but she's not about to give up now. "I've just got to pray really, really hard—and keep doing it," she says. **RF**

### Ten Tough Years (1993-2002)

Manufacturing employment is down dramatically in textiles and apparel



SOURCE: U.S. Bureau of Labor Statistics

Deese, director of work force initiatives for the North Carolina Community College System. Many of them dropped out of high school, and they are nervous about returning to the classroom.

"When I first started out, it was kind of difficult," says Robinson, who turns 50 in January. But she credits the people at Catawba Valley Community College for helping her make the transition. "I couldn't ask for a better advisor," she says. "He has worked with me and my two friends. ... He's guided us over a lot of humps."

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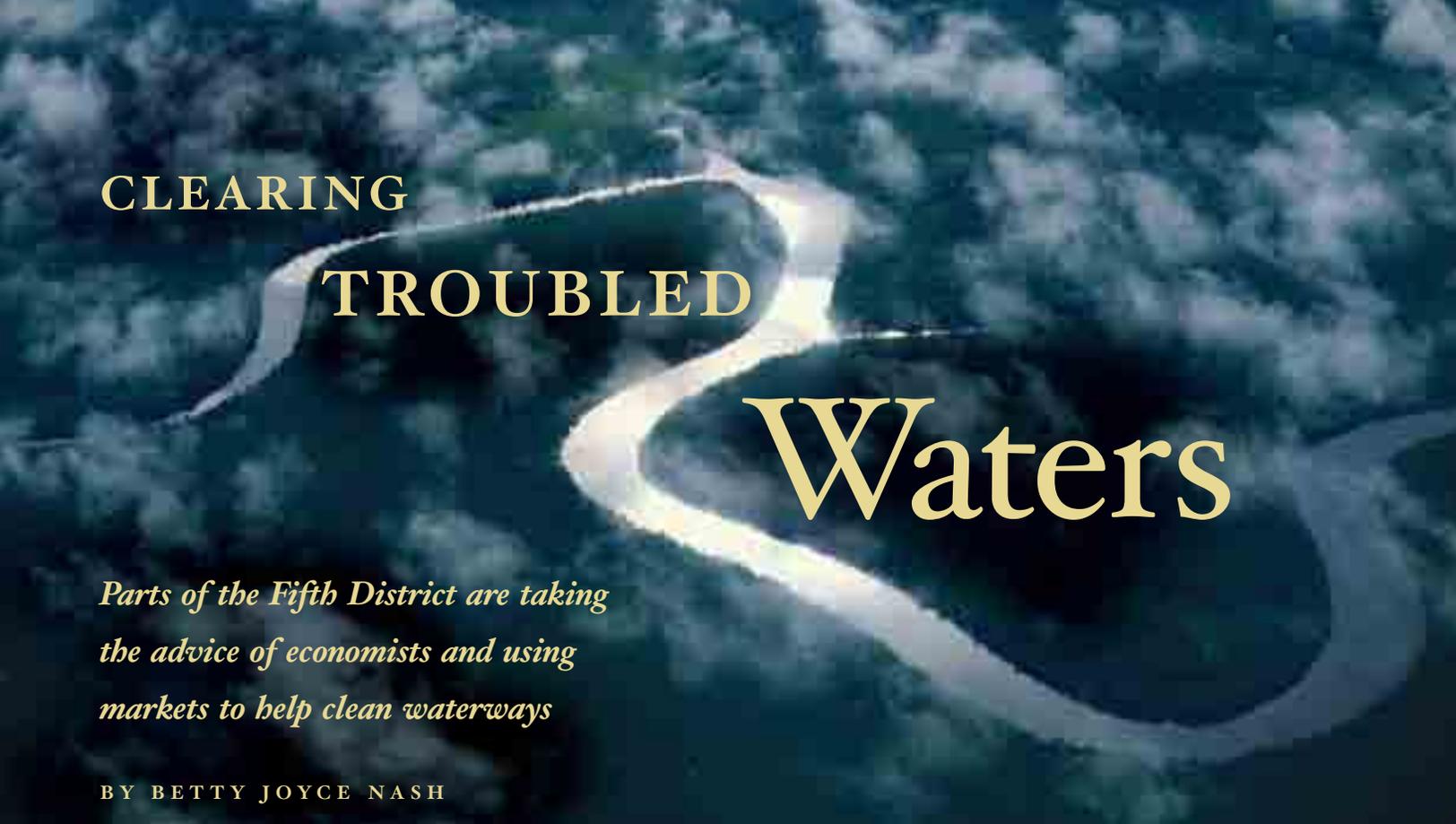
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# CLEARING TROUBLED Waters

*Parts of the Fifth District are taking the advice of economists and using markets to help clean waterways*

BY BETTY JOYCE NASH

It's Indian summer out here on a cornfield ripe for harvest in a chunk of Virginia's coastal plain wedged between the sprawl of Richmond and Norfolk. Dubbed the "good luck tract" as a joke because of its erodible soil and 10 percent slope, the land may prove its worth in a new way.

Agriculture experts Jim Wallace and Brian Noyes from the Colonial Soil and Water Conservation District show off the "good luck tract" and its farmer, David Black. They advertise "continuous no till," or letting the land be, rather than plowing it before planting. After 12 years without tilling, the soil of the good luck tract stays put. Its biologically rich soil (packed with hard-working earthworms) holds its own in a hard rain and traps chemicals that foul waters to boot. Wallace, Noyes, and Black watch the progress of Black's father on the combine harvesting corn and joke that maybe they should pump the entire James River through the field to clean it up.

The good luck's arrested erosion is mighty good news for the James and feeder streams because heavy rains can wash sediment laden with "nutrients"—excess nitrogen and phosphorous (fer-

tilizer)—into rivers and streams. That pollution winds up in the Chesapeake Bay and beyond. Ultimately this over-feeds plant life and chokes off oxygen crucial to a healthy population of creatures. Such runoff is literally killing the bay and is responsible for dead zones in 13 of the nation's 17 most choked bays.

Some policymakers think the power of markets can help cleanse the nation's waterways of nutrient pollution. Market-like trading has been touted as a cheaper way to stimulate pollution prevention and speed compliance. The Environmental Protection Agency in 2003 published guidelines for nutrient trading, which gave the idea official support. EPA even threw in funding for pilot projects. The Clean Water Act's legal limits known as total maximum daily loads, TMDLs, are under development for polluted waters. Those load limits, for the first time, would set caps for pollution in waterways and allocate discharges that could be bought and sold.

That's part of what's motivating farmers, environmentalists, policymakers, industrial users, and municipalities to think creatively. Pollution enters waterways from point sources, wastewater treatment plants, and nonpoint

sources, urban and agricultural runoff. Nonpoint sources are tough to involve in a trading scheme even though runoff dirties water considerably. A trading plan might allow a farmer like David Black to put his carefully nurtured soil to work, says Jim Wallace.

"Luckily for us, [the soil's] natural function is pollutant removal which is what we're going to try to achieve a credit for."

## The Market Mantra

Putting markets to work using trades among pollution sources dates from the late 1960s in economic literature. The notion's time seems to have come. Regulatory reform has gained ground in political circles with both Republicans and Democrats endorsing trading programs of various kinds. A trading plan, after all, is helping clear the air of sulfur dioxide and will have saved more than \$500 million in compliance costs by 2005. Cap and trade programs are more likely to meet environmental goals, say economists. Unlike traditional rules, which allow pollution to grow with the economy, a cap recognizes the public has a "property right" to a limited level of a pollutant.



BETTY BOYCE NASH / FEDERAL RESERVE BANK OF RICHMOND

*Mark Alling, of Virginia's Department of Environmental Quality, samples water from the James River after Hurricane Isabel.*

Trading programs typically work by setting an enforceable limit and allowing a group of dischargers to buy and sell from each other to achieve it. It's cheaper for some plants to cut pollution than others, depending on size, age, and other variables. Sources can trade among themselves and figure out how to meet water quality standards. Flexibility inherent in trading creates incentives for firms to explore alternatives as they look for the biggest bang for the buck. Dozens of nutrient trading programs already operate nationwide, two in the Fifth District (North Carolina).

Economists say there's no way a regulator can know the cheapest method of pollution control. Yet traditional command-and-control environmental policy is based on prescriptive cleanup solutions rather than incentives to find cost-effective solutions. Firms aren't willing to invest in finding cheaper ways to cut pollution unless there is a benefit from doing it. Until they make that investment, they won't know how cheaply it could be done, economists say. While it's possible to calculate the cost of equipment and operations currently in use, it's impossible to calculate what firms could do if they had incentive, according to Virginia Tech

economist Kurt Stephenson, who has written extensively on water trading.

With a trading program, the incentive to invest in new technology arises because firms now face what economists call an "opportunity cost" for pollution discharges. This cost comes from the opportunity firms have to sell the pollution allowance at a profit rather than using it. Reduce pollution, sell allowances, make money. That's opportunity. "As an economist it drives me crazy listening to people from the states saying repeatedly we know what needs to be done," Stephenson says. "But the people running the plants know their costs and they'll figure out what needs to be done." Innovation evolves quickly under a market that puts a premium on development. A requirement for air pollution scrubbers on power plants illustrates his point.

"They were expensive and unreliable and then all of a sudden with the flexibility of the sulfur dioxide program, the scrubber industry had to compete with low sulfur coal and allowances. The reliability went up and prices went down." (See Federal Reserve Bank of Richmond's *Cross Sections*, "Pollution Allowances Help Clear the Air," Winter 1996/1997.)

Under a conventional regulatory framework, where firms receive permits to limit individual discharges, the only reward for innovation is tighter standards, write Stephenson and co-authors James Boyd and Leonard Shabman of the Washington, D.C., think tank Resources for the Future. By contrast, a trading scenario encourages participants to figure out how to meet an overall goal and generate a marketable allowance.

Nonpoint sources (currently unregulated) could participate in a trading system in a variety of ways, despite difficulties measuring nutrient runoff from diffuse sources. For example, point sources could buy credits from nonpoint sources that could adopt certain strategies documented to reduce runoff. A trading program shifts regulatory resources away from engineering pollution fixes toward measuring and monitoring pollution loads, Stephenson says.

## The Tar Heel Traders

In North Carolina, a sense of urgency drove stakeholders—farmers, treatment plant operators, and environmentalists—to trading because nutrients from farms, especially livestock operations, and treatment plants were fouling waters. That, in turn, spawned fish kills, and threatened the state's tourist industry in a big way. The state declared the Tar-Pamlico River basin "nutrient sensitive," thus tightening environmental controls. Malcolm Green, of the Greenville Utilities Commission, got behind trading early on. In 1989, Green and 12 other wastewater treatment operators in the basin formed an association and funded a \$400,000 model to compute the necessary reduction levels. Cash-strapped municipalities paid up, Green remembers, because the alternative potential costs of improvements under traditional regulations would have cost much more.

"We went to the 30 percent basin-wide reduction goal [from 1989 levels]. No one plant had a goal." The state agreed to treat the group as one. The association was assigned a fixed number of allowances, with enforceable penalties for failure to meet the cap. The association allocated allowances among its members, with freedom to trade among themselves. The association hired a consultant for advice on how to tweak plant operations for efficiency. The results surprised everyone. "We got 80 percent of the reduction number just by hiring this person."

Green says the association has traded some with farmers in the basin to ensure the success of the program but reports that most trades occur within the association. "We got so good at it, we never had to do a lot of point to nonpoint but we have done it... What we have done is bought credits by paying farmers to do some reductions," he says. In the trading program's second phase, basin farmers collectively are required to cut nitrogen by 30 percent by 2006 through conservation practices.

Working out the science and economics of trading is tough enough but getting people to buy in is tougher. Environmentalists, for example, tend to distrust market programs because

they figure the profit motive helped pollute the waters in the first place. David McNaught, a policy analyst with the environmental advocacy organization N.C. Environmental Defense, was executive director of the Pamlico-Tar River Foundation when the agreement was under negotiation. Environmentalists believe the cap was set too high and that the plan's omission of non-point source participation in its first phase was a mistake, he says. Yet compromise was critical for cleanup. Environmental Defense has gained a reputation for seeking out market solutions because the group wants results.

"They knew we weren't likely to solve water quality woes with taking hard line regulatory approaches," McNaught says. "We needed affirmative approaches people in the business community

would embrace." The Tar-Pam program is proving resilient after almost 15 years, but the plan is up for renewal this year and the environmental community will be watching and working to see non-point pollution sources comply, according to McNaught.

Green says the state remains hands off unless the association busts its cap. As plants expand, as have two-thirds, they install biological nutrient removal technology. The association has hired a full-time employee for the state to work exclusively on the trading program.

"That person was a big help when we went in to sell the program to the farming community," Green says.

Stephenson says the beauty of the Tar-Pamlico program is the creativity that flourishes in the absence of command and control regulation.

"They did a whole bunch of these [improvements] the regulators didn't even think of." Up until the trading strategy, none of the plants had ever operated more efficiently than they had to because, lacking incentive, they didn't know how.

Farms in the Tar-Pamlico and Neuse River (also under a trading plan) basins file management plans to show how management practices reduce by 30 percent the amount of nitrogen. They're awarded credits for each practice they introduce, such as stream buffer installation, and a committee from each county compiles reports for the state.

### Trading: Design Counts

Practitioners and economists debate the nature of a true market-based program, says environmental consultant Mark

## Trading For a Cleaner Chesapeake

Mark Alling hauls his sampling bottle out of the James River. The water looks like weak tea with some floating gunk in it as Alling transfers it to an inflatable jug for its journey to a Virginia Department of Environmental Quality lab. Alling expects the river to show the effects of Hurricane Isabel, the storm that swooped down on the Virginia and North Carolina coasts last September.

"I would expect the nutrients to be high. There's more sediment load coming down in higher flows and nutrientsglom onto the sediment flow," says Alling, a biologist who is manager of DEQ's Piedmont regional office. He explains that nitrogen and phosphorous are flushed into the river by heavy rains. Since 1984, the water on all the tributaries of the Chesapeake Bay has been sampled for nutrients as well as other signals of its condition. The numbers are crucial for determining the Chesapeake Bay states' tributary strategies. Those plans are due this spring to the Chesapeake Bay Program, a nonregulatory arm of the Environmental Protection Agency. They'll help map out states' blueprints for cutting the pollution flowing into the bay.

"It will assign responsibility to wastewater treatment plants, farmers, and so on," says Bob Rose, of the program office. The strategies will document "who's here, what they're putting in now and how low they'd have to go."

All that information could help in designing

nutrient trading plans to cut levels of nitrogen and phosphorous coming into the bay.

The Chesapeake Bay, under serious scrutiny for nearly 20 years, still absorbs an estimated 285 million pounds of nitrogen a year, down from 338 million pounds in 1985. A new, voluntary agreement, in effect until 2010, calls for 175 million pounds a year, twice the amount achieved in the previous years.

The current nitrogen level is some 500 percent more than historical levels, says Rose. "I don't know if people realize how bad that is," he says. The water quality in the Chesapeake Bay last summer even sent the crabs scurrying onshore because they couldn't breathe. Summer's warmth along with too much nitrogen and phosphorous overfeeds plants, depleting oxygen necessary to support marine life. Last summer, the bay's low-oxygen zone extended from Baltimore to the Bay Bridge. Scientists estimate that up to 25 percent of the entire volume of the bay's water suffers from low or no oxygen for much of the spring, summer, and fall.

Solving the bay's nutrient problem won't be cheap. Estimates by the Chesapeake Bay Commission put the cost at nearly \$19 billion. Environmentalists doubt that a voluntary agreement can achieve bay cleanup goals.

Rose explains that "the hope is that by 2010 we can avoid having traditional regulations. We really want the cooperative, multistate effort."

For example, Maryland, Virginia, and Pennsylvania farmers file "nutrient management plans" to cut runoff. (However, Maryland is the only state where the plans are mandatory.)

If the voluntary efforts fail, however, the TMDLs, legally binding caps, will kick in, with the force of permits and fines for violation.

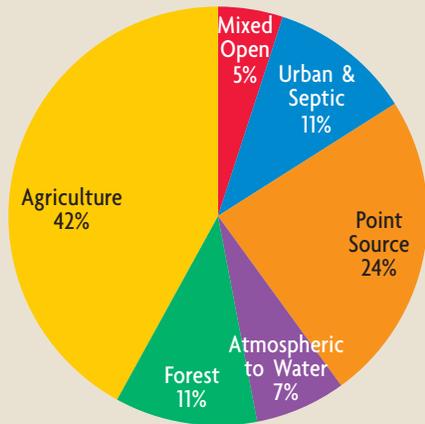
Among myriad voluntary efforts, the Chesapeake Bay Program has also investigated trading for the bay. In a watershed the size of the Chesapeake, ranging over 64,000 square miles and parts of six states, trading will prove challenging. The guidelines, published in 2001, ruled out watershed-wide trading. "We felt it could be viably done in riverbeds," says Roy Hoagland, Virginia executive director of the Chesapeake Bay Foundation. Even that's tricky as many rivers, like the Potomac, flow through several states. Also, Hoagland wonders, given that erosion and runoff contribute heavily to the bay's degradation, how can trades be managed from point to nonpoint?

Policymakers will wrestle with such questions as states hand in tributary strategies this spring and incipient trading plans in Maryland and Pennsylvania inch forward. As Hoagland points out, trading sounds reasonable, but the devil's in the details.

"From the Bay Foundation's perspective, though, any tool that helps reduce nutrients in the bay is something we want to try," he notes.

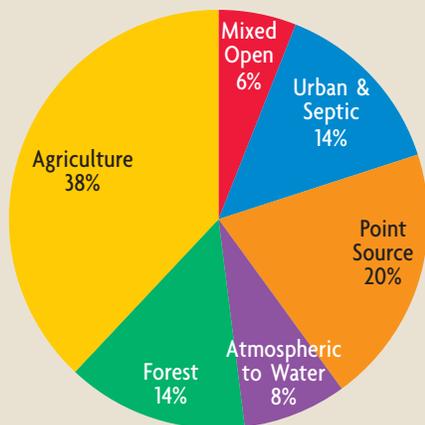
— BETTY JOYCE NASH

## Sources of Nitrogen Loads to the Chesapeake Bay



1985

Total Load: 358 million pounds



2000

Total Load: 305 million pounds

SOURCE: Chesapeake Bay Program

Kieser of Kieser & Associates of Kalamazoo, Mich.

“For example, look at the Connecticut-Long Island Sound program,” he says. “They’re looking at hundreds of millions of dollars in savings. Some might not call that a true market-based program [because] the trades are highly regulated.”

Trading programs come in a wide variety of styles and sizes, some more marketwise than others. The distinction between a directive program,

where trades are dictated, and a true market approach is important, say economists.

Connecticut’s trading plan, developed in 2002, is strictly regulated and applies only to wastewater treatment plants. Under the gun to reduce nitrogen 60 percent by 2014 to comply with a TMDL limit for Long Island Sound, the program put 79 plants under one permit, according to Gary Johnson. He is senior environmental engineer for the Connecticut Department of Environmental Protection. Plants were given individual permits, too. “The way the trading program works, if you do better than the numbers on your permit, you then had credits to sell,” he explains. “If you didn’t do as well as prescribed in [your] permit you had to purchase credits.” To oversee the sale and purchase of credits, the legislature created a nitrogen credit advisory board.

Johnson says the program is cutting nitrogen ahead of projections. Some 25 of 79 plants have made capital improvements. The rest are in the throes of engineering studies to figure cost estimates.

Plants weigh the economics of buying credits versus making improvements. For a community that’s just built a new high school, purchasing credits might delay a huge capital expenditure for a few years.

“We have them look at the economics of it. What would happen if we make a modest improvement now versus a significant improvement now?” Johnson says. “If you can imagine taking 79 treatment plants to the highest level of treatment – if someone can get themselves two-thirds of the way there, and purchase credits for the difference, that can save a lot of money.” At the end of the year, the board sets a value for a credit and the state offers to buy excess credits.

Although Connecticut’s trading plan is a cap and trade, it’s not a pure market, says Dave Batchelor, who is a senior policy adviser in EPA’s water office. “It’s a highly managed regulatory market, but it did capitalize on economies of scale and it demonstrates how markets provide incentive for early reductions.”

The way economists see it, the truer to a market a trading plan, the more potential it has for achieving water quality goals better, cheaper, and faster. And as pollution loads are quantified under EPA’s daily load limits, water quality regulation is moving in the direction of cap and trade programs. Such plans, however, require watershed assessment, monitoring, and enforcement tools to guard environmental quality and preserve flexibility, according to Shabman, et al.

More trading plans are emerging as treatment plant operators prepare for the maximum pollution limits (TMDLs). In the Fifth District, the Maryland Association of Municipal Wastewater Agencies (MAMWA) hopes to implement a trading plan, according to Cy Jones, of the Washington Suburban Sanitary Commission. Using the Tar Pamlico, Neuse, and Long Island plans for inspiration, Jones says the group culled the best from each. The proposal would create four trading associations in Maryland river basins, with each receiving an overall allocation for the plants in its basin. Allowing plants to share the burden and trade among themselves uses economies of scale, Jones observes.

“Upgrading large plants but not small plants [makes sense] because you don’t get much in the way of nitrogen reduction when you spend money to upgrade a two-million-gallon-a-day plant as opposed to a 30-million-gallon-a-day plant. The small plant helps fund the large treatment plant.”

Eventually, MAMWA’s as well as other trading plans will have to work with nonpoint sources. And that’s no easy task, given historical reluctance to regulate nonpoint sources and the difficulty assessing pollution where there’s no pipe.

MAMWA aims to go directly to farmers to state the case for trading. “Farmers are skeptical of trading. They say it’s a way for wastewater treatment plants to avoid their own responsibilities. We want to dispel that misconception. [We’ll] see what comes of that and maybe even execute some sample trades to demonstrate that all three parties, wastewater treatment plants,

farmers and the Bay can all be winners if we do these trades properly.”

### Trading and Agriculture

Farmers in Virginia’s Colonial Soil and Water Conservation District believe that, too, according to Brian Noyes and Jim Wallace. That’s why they advertise no-till farming, which is part of a program called innovative cropping systems (ICS), a set of conservation practices the farmers in their district have helped pioneer. ICS includes spoon-feeding crops with nutrients to make sure excessive fertilizer is kept off the fields (and, by extension, out of the waters).

“On a wheat crop that probably needs 125 to 140 pounds per acre of nitrogen, they will make four applications of nutrients as opposed to putting it out there at one time,” Wallace explains. “The farmers are also taking tissue tests to figure how much is in the plants and how much it needs.” New technology can detect chlorophyll in plants and signal to a sprayer an appropriate ration. Pretty neat, but expensive. “Research has shown a reduction of 30 percent to 40 percent nitrogen. That means you’re saving on your input costs.”

For 30 years, some farmers in the area, east of Interstate 95, have planted no-till soybeans and most have stopped tilling for other crop rotations, too. “So, our farmers have employed this practice where they never have to till the soil,” Wallace says, saving fuel and money and time. It benefits the farmer and the soil, which is loaded with organic matter. The soil then performs a natural function of storing pollutants such as carbon (a factor in global warming) and nutrients.

What the farmers would like is payment for this storage. “We feel like we can show the farmers are able to reduce pollutants entering waterway by employing this practice. And that should generate a tradable credit. Farmers get a shot in the arm—a fiscal shot in the arm.

“We have been talking about trading in one form or another for about three years,” Wallace says. “So we started looking at nutrient reductions that would be achieved through using

ICS. We find ourselves in the lower James watershed with multiple point source dischargers, wastewater treatment plants, 20 percent of the state’s population, military bases, industrial, and so on with Chesapeake Bay goals and tributary strategies, and looming over our heads the TMDLs,” he explains. It might be cheaper for pollution sources to pay his farmers for credits than it would be for them to reduce the pollution.

Wallace credits district farmers such as Black with a progressive streak. “They’re always looking to see how they can become more efficient.”

But while farmers in the Colonial Soil and Water Conservation District might be tending the heck out of soil in their own back yards, that’s not true everywhere. For example, poultry waste from West Virginia to the Delmarva Peninsula affects water quality as does manure from hog farming in North Carolina. Millions of tons must be managed daily to keep waste from polluting waterways.

And in a market-based trading program, if economists had their druthers, nonpoint sources would be capped, too. And McNaught of N.C. Environmental Defense says the health of waterways depends on “the elephant in the room,” nonpoint pollution.

In fact, the Tar-Pamlico and Neuse River plans do limit farm runoff, says Dave Moreau, chairman of the N.C. Environmental Management Commission.

“Each of the farms in the Neuse Basin (same applies to the Tar-Pam) had to file a nutrient management plan. And they have to show by adoption of best management practices a reduction of 30 percent nitrogen from 1995 levels,” Moreau says.

Regulating agriculture is traditionally difficult, especially in states where the sector remains a big player in the economy, but it eventually came about in North Carolina. In the 1990s, the fish kills got everybody’s attention. Moreau explains: “The coastal interest began to raise all manner of Cain.”

To some extent, trading ratios can accommodate the uncertainty involved in nonpoint to point trades, says Suzie Greenhalgh, senior economist with the

World Resources Institute, a nonprofit group located in Washington, D.C.

“If you have a point source with known discharge but nonpoint sources with diffuse discharges, there’s quite a bit of uncertainty attached to that,” she notes. “If you are a point source that needs to reduce by one pound, a farmer would sell two pounds of credits for each pound...to deal with uncertainty attached to reductions coming from nonpoint source. To me that’s a very good way of dealing with it.”

The biology behind clean water is demonstrating that nonpoint sources need to be involved in pollution control. Jim Boyd of RFF writes that “the low-hanging fruit of...point-source reductions has largely been harvested.” Economists and others say trading programs are one way to keep costs low enough so that nonpoint sources can be part of the pollution solution. **RF**

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# Dollars *in the* Dirt

## The Economic Value of Living Trees

BY BETTY JOYCE NASH

**E**ngineered efficiently by nature to produce a superb building material, a felled tree's worth has been well documented — the United States produces \$230 billion in wood products annually. But it has taken awhile for the silent contributions of living trees to be quantified.

Trees are now recognized for performing all sorts of environmental services. They trap carbon dioxide, a chief culprit in global warming. They absorb and filter water — Fifth District residents drink from waters that originate in the most biologically diverse forests outside of the tropics. And, they clean the air we breathe, trapping particles believed to cause respiratory diseases. That's especially useful in Fifth District states, which are among those with the highest mortality rates from pollution-related respiratory ailments.

As the boundaries between urban and rural areas blur, the economic benefits of living trees are coming into sharper focus. "Urban dwellers have different values towards nature," says Ed Macie, a regional urban forester for the

USDA Forest Service's Southern Region. "Timbering might become less acceptable and air and water quality might become more important."

American Forests, a Washington, D.C., nonprofit group established in 1875, is working to quantify these economic benefits. "We're trying to find ways to incorporate [them] into daily decision making," says Gary Moll, vice president of urban forestry. This would be a big improvement from what Moll saw while working as a state forester 20 years ago. Local officials made policy decisions without realizing how nature contributes to air and water quality.

### The Carbon Sink

Trees collect carbon for a living. Some companies are picking up on this process and planting forests to combat global warming.

Trees absorb carbon dioxide from the atmosphere and convert it into carbon-based compounds through photosynthesis. Some of the carbon is used for food and the rest is stored. The amount of carbon retained depends on a forest's health and age, among other factors. An acre of mature trees can store from 150 tons to more than 400 tons of carbon annually.

"Many utilities are looking for ways to offset the carbon they produce," notes Macie. And planting trees is a good way to do it — carbon remains in wood until fire or decomposition releases it.

The United States hasn't approved the Kyoto Protocol, a 1997 international agreement to reduce atmospheric carbon dioxide. Still, companies have decided to start offsetting carbon emissions now because they see some sort of regulatory requirement as inevitable, explains John Rogers of the Conservation Fund, an Arlington, Va.-based nonprofit.

Energy companies have been among the first to come to the table. "Their overt motivation is recognizing their con-



tribution to greenhouse gases, and that there's a high scientific likelihood it is causing global warming," says Rogers.

In Mississippi, Entergy Corp. helped the Conservation Fund buy 600 acres for the new Red River National Wildlife Refuge. The firm hired Atlanta-based Environmental Synergy Inc. to plant bottomland hardwoods that will absorb an estimated 275,000 tons of carbon dioxide over the next 70 years. In Louisiana, the Conservation Fund bought 700 acres near the Tensas River with Chevron/Texaco's money. The land was reforested and then turned over to the U.S. Fish and Wildlife Service as a National Wildlife Refuge. A similar deal reforested 1,800 acres in Louisiana using funds from American Electric Power Company.

Reforestation is a long-term proposition, says Joe Wisniewski, who heads Environmental Synergy. In its five-year history, his company has planted 18 million trees over 60,000 acres in the South, none in the Fifth District.

Wisniewski believes a carbon trading mechanism in the United States is looming as countries across the globe adhere to the Kyoto agreement and states like North Carolina ponder the possibility of limiting carbon emissions. Global energy companies want to play by one set of rules, and that creates incentives for them to act now.

Storing carbon today could pay off for companies tomorrow if Congress provides them with pollution credits in return. Such credits could be used to meet pollution goals or be sold to other companies (see sidebar).

Carbon storage is already becoming useful to some landowners. For example, the U.S. Department of Agriculture has said it will consider carbon storage when evaluating applications for incentive programs and conservation initiatives.

While companies plant forests to absorb carbon dioxide, the uprooting of trees elsewhere adds to the global warming problem. An estimated 25 percent of the increase in atmospheric carbon dioxide is blamed on tree losses due to changing land-use patterns, notes Rogers. Metropolitan areas, especially those in the fast-growing Southeast, continue to bulldoze forests and

## Carbon Counts

In the United States, an estimated 1,560 million tons of carbon dioxide enters the atmosphere each day. Energy use accounts for more than 80 percent of these emissions, according to the Pew Center on Global Climate Change, a nonprofit group formed in 1998 to study global warming.

Greenhouse gases like carbon dioxide have been blamed for heating the globe by about one degree F over the last century. Scientists predict a global increase of 2.5 degrees F to 10.4 degrees F by 2100, which will likely raise sea levels and change rainfall patterns. Economists at the Pew Center say markets can yield innovative solutions to these looming problems and change the behavior of private firms.

Although, the United States doesn't regulate carbon dioxide emissions, legislative proposals regarding climate change have increased from seven in the 1997-1998 session to more than 31 in the current session. Two lawmakers, Sens. Joseph Lieberman (D-Conn.) and John McCain (R-Ariz.), introduced a bill in 2003 that calls for a market-based solution. And that appeals to economists, says Neil Strachan, senior research fellow at the Pew Center. (The bill was defeated in October, although Lieberman views the 43-55 vote to be an "important moral victory.")

"In an emissions trading system, there is a cap on the total amount of pollutants that can be emitted—if you want to emit any tons of carbon dioxide you have to obtain a permit," Strachan explains. Permits are either given away or

auctioned off in a one-time offering, but become valuable because supply is limited. "Because you have a cap on the number of tons of pollution, these permits have value. If you want to join the market and open a power station, you have to go out and buy these permits."

Companies have the option of continuing to purchase permits to meet standards, or reducing pollution. Firms with extra permits can sell them to those for whom it's tougher to cut emissions. Or, the permits could be banked. "The most important aspect of an emissions trading scheme...is that it allows for flexible compliance," notes Strachan. "Rather than telling power plants you all have to reduce [emissions] by 10 percent, if you set up a market, a firm can decide to reduce by 10 percent or 50 percent or nothing."

An emissions trading system has already been successful in reducing the production of sulfur dioxide, which combines with other pollutants to create acid rain (see *Cross Sections*, Winter 1996/1997). Between 1995 and 1999, a trading system enabled power plants to slash sulfur dioxide emission levels by 22 percent below required levels.

While a national trading scheme for carbon dioxide may be some years away, states are acting now. The governors of 10 northeastern states announced in July they will work together to develop a regional cap and trade program for carbon dioxide emissions from power plants.

—BETTY JOYCE NASH

lay down pavement. Northern Virginia, for example, loses 28 acres a day to development.

## Pollution Prevention

Replacing lost forestland can have another benefit as well—a tree behaves like an elaborate pollution control device. Its leaves absorb and filter rainwater, while its roots cleanse stormwater runoff before it reaches waterways and reservoirs, the source of most peoples' drinking water.

Forests usually produce cleaner water than developed land, so cities throughout the United States are defining watershed areas and acquiring forested land or conservation easements to protect their water supplies. New York City, for example, has main-

tained the largest, unfiltered water supply in the world by protecting its source high in the Catskill Mountains. Similarly, Asheville, N.C., has used easements with property owners to protect over 17,000 acres surrounding its water supply.

Protecting source water by preserving the surrounding forestland may be more cost effective than removing pollutants after the fact, according to Doug Ryan, a forest service analyst. Until about 1990, water treatment was regarded as an engineering problem, focused on removing impurities instead of preventing pollution at the source.

"What we're discovering now is that more rigorous treatment can leave more residues in the water that are harmful to people..." Ryan noted in a 2002 Forest

## Forest Area in the United States<sup>a</sup> (In Thousands of Acres)

State	1997	1987 <sup>b</sup>	1977 <sup>c</sup>	1963 <sup>d</sup>	1953 <sup>e</sup>	1938 <sup>f</sup>	1907 <sup>g</sup>	1630 <sup>h</sup>
Maryland	2,701	2,632	2,653	2,920	2,920	2,595	2,200	5,730
North Carolina	19,298	19,281	19,913	20,662	20,113	18,400	19,600	29,630
South Carolina	12,651	12,257	12,569	12,250	11,943	10,704	12,000	17,570
Virginia	16,047	16,108	16,387	16,412	16,032	14,832	14,000	24,480
West Virginia	12,108	11,942	11,669	11,469	10,327	10,074	9,100	14,610
Washington, DC*								

\*Data unavailable

a Estimates for 1938 include forest area for regions that would become the States of Alaska and Hawaii. All data prior to 1953 are based on partial inventories or estimates from surveyors data. Estimates for 1907 include forest area for regions that would become the States of Alaska, Arizona, Hawaii, and New Mexico. Estimates for 1630 represent the forest area in North America for regions that would become the 50 States within the current United States.

b Data for 1987 based on Waddell et al (1989).

c Data for 1977 based on USDA Forest Service (1982).

d Data for 1963 based on USDA Forest Service (1965).

e Data for 1953 based on USDA Forest Service (1958).

f Data for 1938 based on U.S. Congress (1938).

g Data for 1907 based on Kellogg (1909).

h Data for 1630 were also from Kellogg (1909) as an estimate of the original forest area based on the current estimate of forest and historic land clearing information. These data are provided here for general reference purposes only to convey the relative extent of the forest estate, in what is now the United States, at the time of European settlement.

SOURCE: USDA Forest Service

Service publication. "New methods of treatment are also becoming more expensive, and passing those costs on to consumers is not a popular move."

In an effort to quantify the pollution control benefits of forests for policymakers, American Forests used satellite data to document tree cover in urban areas. Then, the group analyzed the effects of tree cover on stormwater runoff, air quality, carbon storage, and other factors.

For example, 46 percent of the Washington, D.C., area is covered in trees, while 27 percent of the land is under impervious surfaces that accelerate runoff and boost temperatures during hot weather. The metro area's tree cover is estimated to kick in \$49 million in air pollution services and \$4.7 billion in stormwater retention benefits each year.

By itself, the District of Columbia doesn't have as many trees working for it. About 22 percent of the city's 36,500 acres are trees and 46 percent are impervious surfaces. The remainder is water and open space. Still, the tree cover annually provides \$2.1 million in air pollution services and \$137.5 million worth of stormwater control.

American Forests calculated the value of a tree's air pollution removal by estimating the amount of certain pollutants deposited on tree canopies, then multiplying by the dollar values

assigned by state public service commissions to those pollutants. The group derived stormwater control amounts by calculating runoff volume in varying land covers.

American Forests also analyzed the 351,000 acres that comprise the Charlotte, N.C., metropolitan area. In Mecklenburg County, which encompasses Charlotte and a few small towns, 22 percent of urban forest disappeared between 1984 and 2001. The county has grown by 72 percent since 1980 and is one of the 10 fastest growing areas in the nation.

Still, the county's tree canopy provides \$1.9 billion dollars annually in stormwater retention services, money that would otherwise have been necessary for infrastructure to handle runoff. It also absorbs about 17.5 million pounds of air pollutants each year, a value estimated at \$43.8 million, plus nearly 62,000 tons of carbon.

"The more forest cover in an urban environment, the less water runs off and the more money you save," says Macie of the U.S. Forest Service. It's not rocket science. "What happens is...we have three inches of rain, it fills our creeks and we have flooding. To compensate for that, we widen the creeks and pave them with concrete. That has a cost."

That's why Charlotte paid \$150,000 from state, city, and private funds to assess its tree cover, says Rick Roti,

chairman of Charlotte's tree commission. The information will allow planners to consider tree canopy as a "green layer" in decisionmaking.

"There's also a huge benefit from a water quality perspective," adds Roti. The rapidly growing Southeast faces water quality issues in a big way because of excessive sedimentation caused by land clearing.

Somebody's paying attention. When Ford Motor Company renovated its historic Rouge assembly plant on the banks of the Rouge River in Dearborn, Michigan, the \$2 billion project included the world's largest "living roof." About 500,000 square feet of vegetation will hold several inches of rainfall. The factory complex also includes massive tree plantings and porous paving as well as shallow ditches seeded with indigenous plants to filter 10-20 million gallons of rainwater annually. The natural roof cost \$15 million, compared to the estimated \$50 million cost for a conventional tar roof, gutters, pipes, sewers, and water treatment systems.

Leveraging Mother Nature to save money is still in its infancy. Businesses will likely find other ways to extract economic value from trees. For example, shade trees next to a building reduce the need for climate control in the summer, cutting electricity demand and carbon dioxide emissions from power plants.

"If you shade your house, you use less air conditioning," says Macie. "Even the cows know that, but as humans we have to remind ourselves." **RF**

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# On Hold

*Fifth District Call Centers Are Shedding Workers Due to Technological Improvements and Globalization*

BY CHARLES GERENA

In the late 1980s, the owner of several Domino's Pizza franchises in Richmond, Va., decided to try something different. Instead of placing their orders for pepperoni and onion pies at the Domino's around the corner, customers throughout the city dialed a single phone number. Telephone agents at a central facility took orders, then transmitted them to the branch location closest to the customer.

Such facilities, known as call centers in the teleservices industry, established a major presence in the Fifth District during the last decade, clustering in places like Greensboro, N.C., Huntington, W.Va., and Virginia Beach, Va. ReferenceUSA's database lists nearly 250 telemarketing bureaus in the region, while the U.S. Census Bureau counted more than 400 telephone call centers in 1998.

Call centers found the affordable and available labor they needed in Fifth District communities, as well as access to communication lines and office space. In turn, they often provided the economic benefits sought by local

development officials. But in the last few years, the teleservices industry has slowed its expansion in the United States and chased cheaper costs abroad.

If this story sounds familiar, it's because textile makers and other manufacturers have done the same thing. They moved into the region to utilize its labor supply and other advantages, but employment levels eventually began a steady decline in response to pressures from abroad and domestic changes in technology use and labor utilization.

Will teleservices answer the same call? "In the last 20 years, the industry has certainly gotten more mature," says Tim Searcy, executive director of the American Teleservices Association (ATA). "It does a much better job of targeting customers [and] picking sites for [call centers] ... Technology continues to make us more efficient." In addition, Searcy foresees less demand for American telephone agents due to the increased use of offshore workers and an overall drop in telemarketing business once the National Do Not Call Registry is enforced.

Telemarketing may be the most infamous sector of the teleservices industry, but call centers handle a variety of back-office functions. These functions fall under two categories— inbound, where telephone agents process calls from customers, and outbound, where agents initiate the calls. The inbound side of the industry encompasses tasks like customer service and support, travel reservations, and catalog order processing. The outbound side includes polling and market research, fund-raising, collections, and telemarketing.

Toll-free customer service and telephone sales have been around for decades, but it wasn't until the 1990s that teleservices emerged from the back office to the front burner of business plans.

According to Brad Cleveland, a teleservices consultant, companies realized they could gather valuable information from customers' phone calls for use in market research, new product development or cross marketing. "The call center is an intelligence machine," describes Cleveland, president and CEO

ALTP

of the Incoming Calls Management Institute (ICMI) in Annapolis, Md.

At the same time, better technology enabled telephone agents to do more for callers, meeting consumer demand for convenience and speed. “Call centers are learning to do a lot more than just handle a bunch of contacts,” notes Cleveland. “[Agents] have at their fingertips access to information in real time that they didn’t use to have. You don’t have to have a ‘back-and-forth’ over a certain number of days or hours.”

Most companies operate call centers in-house. Sometimes they have small groups of agents working at different offices, while others with a large call volume have facilities dedicated to tele-services. In order to reduce their overhead and have more flexibility, some firms have outsourced teleservices to contractors with their own facilities.

With the growth in teleservices during the 1990s, call centers sprung up nationwide. In the past, they had to locate near a company’s customer base in order to minimize communications costs, according to Cleveland. But distance became a non-

issue due to the rapid deployment of long-haul telecommunications networks.

A more important consideration for a call center operator has been finding a place that can satisfy its appetite for workers. Telephone agents need to be educated and good communicators, but such qualities can be hard to find in the quantities necessary to run a call center.

“The call center may have to be staffed 24 hours a day, and thus require a supply of labor sufficiently plentiful to operate different shifts,” wrote Randal Richardson and Andrew Gillespie of Britain’s Centre for Urban and Regional Development Studies in a 2003 article.

Also, the center must be able to fill vacancies, which can occur with alarming frequency. “Despite the importance of employee satisfaction, the turnover rate in call centers is higher than most other departments in a company,” noted a 2002 white paper by the Purdue Research Foundation and two partner organizations. “The average annual industry rate is around 25 percent, and in some call centers this rate can be between 100 and 150 percent per year.”

Besides the quantity and quality of a community’s work force, the cost of labor must be affordable. That’s because it typically accounts for 60 to 70 percent of a call center’s operating budget, according to the Purdue report.

In order to keep a lid on labor expenses, call center operators have shunned locations with high costs of living because workers in such locations tend to demand higher wages. In a low-cost community, however, a call center can afford to offer competitive wages.

Rural towns like Norton, Va., small cities like Huntington, and mid-sized metropolitan areas such as the Piedmont Triad in North Carolina have all attracted call centers because they had one thing in common—there was less competition for workers and lower costs compared to larger urban areas.

Finally, some call center operators have tried to match seasonal changes in their labor demand with the seasonality of local labor markets. For example, the tourism component of the job market in Virginia Beach enables

Lillian Vernon Corp. to boost employment at its call center from 175 telephone agents to 1,100 during its busy season from September to December. “During the warm weather months, a lot of our employees work in the tourism sector and in the cold weather months they work for [us],” describes David Hochberg, vice president of public affairs at the New York-based catalog retailer.

Labor demand at call centers also fluctuates unexpectedly. For instance, Hamilton Holloway, spokesperson for Capital One Financial Corp., says the McLean, Va., company launched a new product last summer that was more successful than it anticipated—a credit card with a fixed interest rate below 5 percent. So, it shifted some of the additional call volume at its centers in Richmond, Fredericksburg, Va., and two other states to outsourcers.

In general, determining the appropriate number of agents to have on hand “is a very difficult task,” notes Holloway. Therefore, call center operators prefer a work force where some laborers are available on demand. For example, Lillian Vernon and GEICO Corp. located centers in the Hampton Roads region of southeastern Virginia to take advantage of the 40,000 military spouses in the region looking for part-time work. Other companies opened centers near military installations and college towns, where students also seek part-time jobs.

Economic development officials in some of these Fifth District communities actively recruited call centers and other back-office operations. Their goals were threefold—to increase employment, diversify the local economy, and support wage growth.

Certainly, large call centers have been major employers. GEICO staffs 2,000 workers at its call center in Virginia Beach and 3,500 workers at its center in Fredericksburg. APAC Customer Service employed as many as 1,000 people at its telemarketing office in Columbia, S.C., before shutting it down in December 2002. Typically, however, the employment effect is smaller. According to the ATA’s Tom

## Not All Call Centers Pay the Same

Because they handle technical and complicated customer calls, telephone agents who work for software, hardware, and financial services companies earn the highest hourly wages. Those who do more basic tasks for credit card and catalog companies tend to earn much less.

### Hourly Wages of Telephone Agents in Different Industries

Software	\$19.60
Financial	\$18.48
Hardware	\$16.50
Health Care	\$13.00
Utilities	\$12.93
Automotive	\$12.00
Consumer	\$10.77
Insurance	\$10.58
Credit Card	\$9.50
Catalog	\$8.00

SOURCE: Center for Customer Driven Quality, Purdue University

Searcy, the median size for a call center is 100 stations staffed by 150 to 200 telephone agents.

Some call centers house information technology personnel, call management specialists, and other employees in addition to telephone agents. This population of professionals can broaden the employment base.

However, most call centers offer little chance for advancement. "Promotion from basic grade to supervisory level may well be more rapid than in other sectors," note Richardson and Gillespie. "Promotion to management grade in the call center is, however, likely to be more difficult. This is partly because there are few management positions, but also because call centers based in less favored regions are likely to be dominated by inward investors. Managers are likely to be 'parachuted' in."

According to a 2002 survey of call centers, the average starting wage for an entry-level telephone agent was \$12.20 an hour or \$25,575 a year. But wage levels vary according to the type of center. Some centers perform primarily outbound calls, mostly telemarketing. They usually provide entry-level work, but on the low end of the wage scale. In contrast, inbound call centers, which usually provide customer service and support, are more technologically sophisticated in nature. Therefore, they tend to require technical training and pay higher wages.

Judy Rose says that the first call centers in Huntington offered minimum-wage work, but that changed as the types of centers coming to the city changed. "The level of skills that these companies required and the level of pay they offered improved over time," recalls Rose, Huntington's former economic development director. "People with just a high-school diploma [moved] from a retail position to a job where they [were] sitting down, working in front of a computer, and learning communication skills."

Entry-level work isn't as common today at inbound call centers, though. "There are inbound call centers that are still on the simple end of the spectrum [such as] directory information," notes Brad Cleveland at ICMI. "But

the overwhelming trend is towards a more complex environment."

In manufacturing, the skills required by workers tends to decrease as machinery gets more sophisticated and production processes become more streamlined. But in the teleservices industry, technological improvements have resulted in greater demands on the skills of telephone agents. Basic transactions and inquiries can be handled by web sites and automated systems like Interactive Voice Response, which enables users to input information on a telephone keypad or by voice. This leaves agents with the tougher calls to handle. "When customers do need to call a call center, it is generally because they couldn't accomplish something through... other means," says Cleveland.

**T**echnological advances have not only required smarter workers in the teleservices industry, they have also helped reduce the need for labor. Sears, Roebuck and Co. eliminated more than 200 call center positions in Greensboro last March. Capital One closed its Fredericksburg center last December that had employed 1,300 people at its peak.

In general, the teleservices industry is reaching a mature stage in its development. Bill Sims, vice president of investor relations for SITEL Corp., says the Baltimore-based provider of teleservices has grown to a size where it is harder to increase sales at the same rapid pace. "The big guys have slowed down from the heyday when we were doing 25 to 40 percent growth per year."

Since call center operators already have eliminated a lot of their costs through automation and Web-based services, they have slowed new development and turned to improving the efficiency of existing operations. Some companies have closed or downsized their centers, while others have followed the same path as some manufacturers and moved their operations overseas. Countries like India and the Philippines have quality laborers who are willing to accept lower wages than Americans to work the telephone.

Recently, Canada has become a favorable call center location due to its proximity to the United States, its large

population of English-speaking workers, and lower labor costs. Mexico is seen as another teleservices hotspot for companies that need Spanish-language telephone agents.

Employment levels in the teleservices industry also have been affected by the overall economy. The recession and uneven recovery have eroded demand for outsourcers that provide teleservices. And some users of teleservices have retrenched more severely. They include telecommunications providers (NTelos shut down its center in Portsmouth, Va., in 2003), and travel and hospitality companies (InterContinental Hotels Group closed its call center in Cary, N.C., last year).

But teleservices executives are optimistic, pointing out that overall spending on call centers is still growing, albeit at a slower pace, while certain sectors like financial services are growing their facilities. Bank of America, for instance, increased the labor force at its High Point, N.C., center from 1,500 to 1,850 last year. Cleveland says this reflects a fundamental trend in the national economy—the growing use of information. "Knowledge isn't useable unless you can get to it when you need it. Call centers are a big part of that, allowing consumers to pick up the phone when they need services."

The only question is how many agents will be answering and making telephone calls from the United States in the future. **RF**

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# AFTER THE FLOOD



## *Insuring Against Natural Disasters is Risky Business*

BY BETTY JOYCE NASH

**H**enderson County, N.C., is balking at joining the nation's flood insurance program. By signing on to the program, the county would promise to set and enforce requirements, primarily elevating structures in flood-prone areas, in exchange for the ability to buy flood insurance guaranteed by the federal government.

But the county commissioners think that if developers could get insurance—and thus procure bank loans—they would build subdivisions dangerously near the county's picturesque western North Carolina rivers and streams. According to Rocky Hyder, the county's emergency management director, Henderson County has aimed to keep its floodplains agricultural to absorb water in heavy rains. Ninety-eight of North Carolina's 100 counties participate in the flood insurance plan, along with some 20,000 communities nationwide.

Hyder says that neighboring counties participate in the flood insurance program and the result shows. "It encourages development in the floodplain," he says.

Henderson County's dilemma highlights an ongoing debate about federal flood insurance, one that surfaces with each storm and recedes with the water as flood memories fade. As disaster assistance payouts climb after Hurricane Isabel, Federal Emergency Management Agency (FEMA) officials are working hard to sign up people for flood insurance. That way, the program builds premiums to fund claims. But some analysts think the program enjoys

subsidization and is a net cost to taxpayers. Most troubling, the insurance could be stimulating development near beaches and rivers—places that arguably shouldn't be built up at all, especially at taxpayer expense.

"The availability of affordable federal flood insurance, even along eroding coasts, fosters the illusion that government will always underwrite the financial risks of building in areas of obvious hazard," writes Rutherford Platt, professor of geography and planning law at the University of Massachusetts.

While flood insurance and its regulations aim to protect structures and minimize disaster assistance, the rules have made it less risky for people to live next to the water.

"I'm a city and regional planner and I think the biggest policy issue is how to guide development so it stays out of the floodplains," says David Godschalk, a planning professor at the University of North Carolina at Chapel Hill.

Congress enacted the National Flood Insurance Program (NFIP) in 1968 in response to massive floods, the lack of available flood insurance, and rising taxpayer-funded flood assistance. The plan, administered by FEMA, aimed to shift the burden of flood losses away from taxpayers. Twice, in 1973 and 1994, congressional legislation has been passed to correct problems in the system. The 1994 legislation tightened the requirement that lenders refuse to make home loans in flood hazard areas unless their customers buy flood insurance.

An April 2003 General Accounting Office (GAO) report states the NFIP has paid about \$12 billion in insurance claims since its inception in 1968, mostly from premiums collected from individual property owners. Under the program, flood insurance rate maps identify special flood areas, known as 100-year floodplains. Those are areas that have a one percent chance (or greater) of flooding in a given year. The idea was to regulate development and require insurance to cut flood losses. FEMA last year was absorbed into the new Department of Homeland Security.

FEMA spokesman Mark Stevens says the government, without a profit motive, can offer flood insurance at affordable rates while private firms can't. (Private firms sell federal flood insurance and receive administrative fees from FEMA.) The flood insurance program's only "catastrophic reserve" is the U.S. Treasury, from which the program borrowed heavily in the late 1990s after a rapid succession of floods. That money has been repaid.

"[We have] zero outstanding at the moment," Stevens notes. "If there's a multistate hurricane around the corner, that can change." The single most expensive flood in the history of the program was created by Hurricane Allison in 2001, which caused more than \$1 billion in property damage.

FEMA says its policies reduce the costs of repairing flood-damaged buildings and further save \$1 billion a year through floodplain management. (Buildings constructed to NFIP stan-

PHOTO BY

dards suffer 80 percent less damage annually than those not in compliance, according to FEMA.) And every \$3 paid in flood insurance claims saves \$1 in disaster assistance payments, according to FEMA. Today, nearly four-and-a-half million property owners have federal flood insurance, less than half the number eligible for it.

### Beam Me Up, Uncle Sam

FEMA has paid 48,566 claims since 1978 in North Carolina alone, with payments totaling about \$561 million, excluding claims for damage done by Hurricane Isabel.

Floods have become a way of life for folks in Belhaven, N.C. The town of about 2,000, about a mile square, sits three feet above sea level on the Pungo River as the river widens into the Pamlico Sound on North Carolina's coast. The town stayed dry for 40 years after Hurricanes Hazel and Diane hit in the mid-1950s.

In 1996, Hurricanes Bertha, Fran, and Josephine marched in, says town manager Tim Johnson. After the town cleaned up from those three storms, Bonnie whacked it in 1998, and then Dennis passed through and turned around to hit twice. And everybody remembers Hurricane Floyd in 1999. Most recently, the town braced for Isabel last September.

But this time, the town was prepared. Most of the flood-prone properties, about 320 in total, had been elevated. The project cost \$16 million.

Belhaven is the poster child for FEMA's "hazard mitigation," an effort that stems from the 1994 congressional legislation to reform the flood insurance program. The idea is to shed properties that repeatedly flood and overtax the system. The program relocates or elevates structures to avoid future losses. A combination of flood insurance, state and FEMA grants, as well as crisis housing assistance funded Belhaven's mitigation plan, said to be the biggest in the United States.

FEMA hopes projects like Belhaven's will eventually stanch its repetitive losses. In North Carolina alone, there are about 5,500 repetitive loss properties. Nationwide, such proper-

ties represent 38 percent of claims, but account for only 2 percent of insured properties. The GAO reports that about 29 percent of the flood insurance program's policies are subsidized without appropriations to cover them.

The problem stems from policyholders whose structures were built before their communities' flood insurance rate maps were drawn. They are grandfathered into the plan and pay reduced premiums that represent only a part of the risk. The GAO reports the average annual premium for a subsidized policy is \$637, about 35 percent to 40 percent of the true risk premium for these properties. The GAO also points out that the plan's cash-based budgeting method hides the costs of the program and "does not provide information necessary to signal emerging problems, such as shortfalls in funds to cover the program's risk exposure."

Scott Harrington, a professor at the University of South Carolina's Moore School of Business, says that calculating the costs and benefits of the program is tough. "There are some overall subsidy and cross-subsidies from properties that aren't grandfathered," he says. "They also say the floodplain management has saved \$1 billion on average in damage. I don't know of any academic research that has tried to add it all up and see whether this on average is a net benefit. You have to be concerned."

### High Density, High Costs

Escalating costs have also been attributed to intensified use of flood-prone areas, according to a report issued in 2000 by the Association of State Flood Plain Managers. The report blames conflicting local, state, and national policies that encourage floodplain development.

An underlying perception that a government bailout will come in after a disaster has encouraged construction in risky areas—a tendency that economists call "moral hazard."

Some people, flood insurance or not, disregard risk and build near water, according to Tabby Shelton, hazard mitigation coordinator for Horry County, S.C. The coastal county, about

seven to 15 feet above sea level, lies at the mouth of the Waccamaw River. Repeated flooding after Hurricanes Dennis, Floyd, and Irene in 1999 logged enough damage to spark a full FEMA hazard mitigation program. Between city and county, almost 100 structures were demolished or acquired to prevent future claims at a total cost of about \$8 million. But home ties remain too strong for some to leave.

"We have a lot of river rats," Shelton says. "They don't care how many times it floods—they just fix it and go on." And as NFIP comes to grips with its repetitive loss problem, future flood assistance will be unavailable for those who don't floodproof their properties and maintain insurance.

In North Carolina, Hurricane Floyd revealed weaknesses in the flood insurance system. For example, two-thirds of disaster claims for individual assistance after Floyd were for homes outside the special hazard flood areas identified on FEMA's rate maps. Floyd's damage mostly came from flooding, yet most flood-damaged homes were not covered by flood insurance.

Floyd prompted North Carolina to mount a massive flood insurance rate map update, funded partly by \$23 million of Floyd's disaster assistance. FEMA has likewise embarked on digitizing and re-mapping flood zones nationwide, with funds appropriated by Congress.

Still, some communities—especially those with narrow floodplains—may want to follow Henderson County's lead and elect to stay out of the flood insurance program in order to discourage private development in risky areas. **RF**

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Visit [www.rich.frb.org/pubs/regionfocus](http://www.rich.frb.org/pubs/regionfocus) for links to relevant Web sites.

# Randall Kroszner

*Editor's Note: This is an abbreviated version of RF's conversation with Randall Kroszner. For the full interview, go to our Web site: [www.rich.frb.org/pubs/regionfocus](http://www.rich.frb.org/pubs/regionfocus).*

The Council of Economic Advisers (CEA), created in 1946, consists of three members who counsel the President on a wide variety of economic issues. The Council's work is most visible on macroeconomic issues. But its members and their staff also research microeconomic issues, several of which have been prominent of late, including corporate governance reform.

Randall Kroszner, professor of economics at the University of Chicago's Graduate School of Business, joined the CEA in 2001. Much of his academic work has focused on political economy questions, such as what drives deregulation of select industries. His position on the Council gave him an opportunity to witness the give-and-take of the policy process that he had researched from outside government. His time in Washington also demonstrated why neoclassical economics provides a powerful analytical framework for examining new policy questions, such as those that arose following the terrorist attacks of Sept. 11, 2001.

Kroszner recently left his position at the CEA to return to the University of Chicago, where he edits the *Journal of Law & Economics*. He has been a visiting scholar at the Federal Reserve Board of Governors, the International Monetary Fund, and the U.S. Securities and Exchange Commission. Aaron Steelman interviewed Kroszner at the Cato Institute in Washington, D.C., on Sept. 23, 2003.

**RF:** Much of your work has focused on political economy questions. Did your time at the CEA affect your view of the policymaking process?

**Kroszner:** It was interesting to be lobbied by various interest groups. I had written about lobbying, but I actually got to be a participant in the process, perhaps even becoming a data point for one of my future papers. Virtually everyone couches their private interest in a public interest rationale. I don't think that's anything new or surprising. But it's interesting the way that everybody is obligated to talk about the broader good. And what's also very interesting is that I think most people really do believe that. If you gave most of these lobbyists a lie-detector test, they would pass. They really do believe what they are telling you, even if as an economist I would say that what they are arguing for would benefit only a very narrow group. In addition, most of them were quite reasonable about accepting and trying to answer the questions I would pose. No one would just come in and say, "Support this or lose our vote." That's not how these things operate. They always try to give substantive reasons for their positions.

When you spend much of your career working in a certain industry, you begin to see more nuances, you are more willing to give the benefit of the doubt to arguments that to an outsider might seem questionable. That may be why you find so many people who, in general, are free-market advocates but when it comes to their industry, they are willing to say we need this regulation or barrier. And in some cases they may be right—there may, in fact, be a market failure. But the real question is: Should the government take action? I don't believe that markets work perfectly all the time. Virtually all markets are imperfect in some way. But what is the relevant alternative? The alternative can be much, much worse. I am a great believer in the power and importance of free markets for advancing human good. But it's not because those markets work perfectly—it's because I can't think of a better alternative.

**RF:** What role do you think the CEA can play in formulating economic policy?

**Kroszner:** I think the tradition at the CEA basically has been to prevent bad policies from being implemented. Often proposals can sound great and very creative, but economists have a frame-

work to look at them and explain their unintended consequences.

In addition to trying to stamp out bad policies, we also tried to promote good policies. For instance, many of the tax changes—particularly the tax cuts on capital—were things economists had been talking about for decades. There wasn't a big constituency for such proposals, but we said this is the right thing to do if you want to get the most bang for the buck. The President understood this well and did a good job of presenting it to the public.

In a crisis situation, you really get to see the power of economics—especially in Washington, where most people derive their power from having knowledge of the institutions. That was no longer very useful after Sept. 11, because we were in a different world. No one had dealt with the type of issues we needed to deal with after such an astonishing terrorist attack. Do we need something like terrorism-risk insurance? Do we need some sort of support for the airline industry? As economists, we could say, "We understand that demand curves slope down. We understand that there are opportunity costs. We understand people's incentives." That was very important, because we could bring that framework to a new situation and describe what's most likely to happen under a variety of different scenarios. In contrast, people who just had knowledge of the institutions didn't have that, because they had no framework. And since the institutions had changed and their applications were going to be very different in a post-Sept. 11 world, economists got the upper hand and had much more influence. It's really nice to see the power of economics to explain the situation and be very useful as a tool for policy development.

**RF:** There was some expansion of the federal financial safety net following Sept. 11, 2001 — terrorism-risk insurance, for instance. What were the major issues of debate and what do you think of the legislation that actually emerged?

**Kroszner:** There was great concern immediately following Sept. 11 that the insurance markets were not going to be able to accommodate these new

*I am a great believer in the power and importance of free markets. But it's not because those markets work perfectly—it's because I can't think of a better alternative.*

risks quickly. I think we all believed that, eventually, the markets would be able to adjust, but it would take a little time to figure out the calculation of risk and understand what appropriate pricing for that would be. Also, with more time, you have more data. With each passing day without a terrorist event, you now have better information about the likelihood of an event. Still, in the immediate aftermath of Sept. 11, many people believed that this was going to be a real problem for property markets—to be able to go ahead with projects that were underway or even for existing buildings. So the policy question was: Should there be some sort of role for the federal government in providing a backstop with terrorism-risk insurance? We argued that there potentially could be a temporary role the government could play. With that in mind, we thought about how to structure a program that would, in fact, be temporary and not with us forever, like so many other "temporary" government programs. We designed a multiyear program that increased private-sector risk-sharing over time, so that the proportion of losses that the government would cover would decline over time. The objective was to build private-sector capacity, so that the government could eventually exit. When many temporary programs are set to expire, people say, "We can't let that expire. The private sector can't pick up the slack." Well, of course it can't, because the



PAUL HERSHMAN

government has been handling the problem completely and given the private sector no incentive to get involved. We wanted to avoid that trap.

There had been a concern among economists that we weren't charging explicit prices. It certainly would be natural to do that. But the problem was, if we know how to price it, then the private markets could easily do so and there would be no reason for the government to be involved in the first place. Also, I think there is an important lesson here about bringing economics into practice in Washington. If you were to collect premiums over the life of the program, you would have to set up a bureaucracy in order to process those premiums and then there would be discussions of what to do with that money. At the conclusion of the program, you have the bureaucratic infrastructure and a source of revenue in place, and I think it becomes much more difficult to exit from the program. And since we thought it was crucially important to make sure the program is temporary, we thought it would be better to avoid this possible problem.

At first blush, of course, the simple economic solution is always to charge for a good or service that you are providing. But you then have to think about the institutions and filter it through the political economy of Washington. Did we believe that the taxpayer will be better off by not

charging a premium today but increasing the likelihood of eliminating this program and allowing the private sector to take over the risks? I thought the answer was yes, and we were able to convince the President of this. It was quite fun to see the usefulness of political economy—an area I had worked on quite a bit—in practice. It is not a deviation from the fundamentals of economics. Certainly, the first step is to always think about using the price system. But the

second step is determining whether there is an additional cost in the government context that is not there in the private sector context.

**RF:** What do you think were the root causes of the recent corporate governance scandals? And how well do you think the Sarbanes-Oxley Act will address them?

**Kroszner:** When looking at the reasons for the corporate governance scandals, people focus a lot on expertise and the role of independent directors. But there is very little evidence in the case of Enron, for example, that it was a lack of expertise or independence that caused that firm's difficulties. It's similar to Glass-Steagall in a sense: People had a theory about the source of the problem and how to solve it, but they left a lot of pieces out. For example, there has been very little focus on the role of institutional investors. Where were the pension funds who owned 2 percent or 3 percent of these firms' stock? Why weren't they looking at the management practices and asking questions? I think part of the reason is there were a lot of other regulatory rules that discouraged active involvement by institutional investors. We should have been looking at those types of issues right from the start.

It's much too early to tell what the consequences of Sarbanes-Oxley are. I hear everything from it's just a minor cost, all the way to it's the death of the corporation. I think the answer is somewhere in between.

I should point out, though, that one of the big benefits of the way Sarbanes-Oxley was written is that most of the changes have to be implemented by the Securities and Exchange Commission (SEC). So where things may have gone a bit too far, the SEC has generally done a good job of trying to implement changes as reasonably as possible. For instance, the Sarbanes-Oxley definition of a financial "expert" would have permitted extremely few people to qualify. The SEC took a broader view of that, which made the law more sensible. I don't think that Congress had intended to make the definition so narrow originally, but in the desire to do something quickly it acted hastily.

One of the projects that I'm now starting on with Phil Strahan is to try to document how boards of directors have changed since 2000 and really understand both the private market responses to the scandals and also the responses that have been driven by Sarbanes-Oxley. This is an example of an issue that I worked on in Washington, where we had our theories of what the consequences would be from a regulatory change, and now coming back to academia I will have the time to actually look at the evidence.

**RF:** For most of American history, the Democratic Party was known as the free-trade party, while the Republicans tended to favor protectionism. Since the 1940s, though, those roles have largely shifted. What do you think accounts for the change?

*In scholarly publishing, there is a very big tradeoff: You can either say nothing precisely or precisely nothing.*

**Kroszner:** The Reciprocal Trade Agreements Act (RTAA) of 1934 fundamentally transformed both the process and outcome of U.S. trade policy: Congress delegated much of its authority over tariff-setting to the President—a precursor of more recent “fast-track” and “trade promotion authority” legislation—and explicitly linked reductions of tariffs abroad with reductions of tariffs at home. This was the start of a sharp move towards trade liberalization. The durability of this change in the post-war United States was achieved only when the Republicans, long-time supporters of high tariffs who originally vowed to repeal the RTAA, began to support this Democratic initiative in the 1940s. The key to the shift was the institutional structure of the RTAA itself, which increased the incentives for exporters to organize and lobby in favor of trade liberalization, as well as the increase in foreign trade following World War II.

An important lesson from this episode is that the organization and strength of interest groups are not simply given but are shaped by incentives embodied in the laws and regulations governing different areas of economic activity. Policymakers should take this type of response into account when structuring or restructuring any type of economic policy, not just in the trade arena.

**RF:** As editor of the *Journal of Law & Economics*, are you concerned about the state of academic publishing?

**Kroszner:** The typical trajectory for an academic is to have a large stream of papers coming out, say, three or four years after your first academic appointment, and then after you have tenure you turn to doing more book chapters and other things that don't require being bothered by referees. One of the major reasons that people don't want to submit papers to journals is the referee process. The judgments that the referees make are often seen as arbitrary and not particularly thoughtful. I think part of that is because the referees don't have much of a stake in what they are doing. Their comments are anonymous and they typically aren't compensated. So at the *Journal of Law & Economics* we pay referees for their work. I'm not sure that is the best way to handle the process. I have often thought that a Board of Editors, who would take responsibility for the decisions and not hide behind the referees, would act much more responsibly.

Also, at the *Journal of Law & Economics* I reject about one-third of manuscripts out of hand, and I think that saves everyone time and effort. In those cases, I try to get back to people very quickly and suggest an alternative venue. For

instance, some of the papers we receive would be much more appropriate for a law journal. There is no point in wasting referees' time by sending those papers out for comment. But the question of how you get a better review process is very important for people involved with scholarly journals.

In scholarly publishing, there also is a very big tradeoff: You can either say nothing precisely or precisely nothing. And, unfortunately, there is a lot of emphasis on precision and getting absolutely everything right. Getting things right is important. But sometimes people forget about trying to answer important questions and taking a look at the bigger picture.

At the *Journal of Law & Economics*, we have tried to take more chances on interesting papers that may be a bit out of the mainstream, because they are attempting to tackle big issues and are not simply making very incremental contributions to the literature. Unfortunately, it's often hard to find those types of papers. People aren't willing to take chances, because the profession places so much emphasis on precision, often at the expense of originality. At many schools, publishing four or five papers that discuss minor questions will be enough to get tenure. But you really have to take risks to move the discipline ahead. It will generate a lot more research to be wrong in an interesting way than to be right in a boring way.

**RF:** Which economists have influenced you the most?

**Kroszner:** In terms of people's writings, I think Hayek was the greatest influence. He had a very broad perspective and thought very much about the fundamentals of equilibrium concepts in economics. Another person whose work has been of great influence and whom I have met a number of times is Milton Friedman. He made extremely important contributions to economic science and also had a very good sense of how to bring economics to bear on important practical questions. That is very much the Chicago tradition. Economics is not just a set of analytical tools—economics is a way for us to understand how people behave. It's a framework for looking at behavior individually, in the family, in the firm, and in politics.

## Randall Kroszner

### ► Present Position

Professor of Economics, Graduate School of Business, University of Chicago

### ► Previous Positions

Member of the President's Council of Economic Advisers (2001-2003); Visiting Scholar, Federal Reserve Board of Governors and the Federal Reserve Banks of Chicago, Kansas City, Minneapolis, New York, and St. Louis; Visiting Scholar, International Monetary Fund; Visiting Scholar, U.S. Securities and Exchange Commission

### ► Education

B.S., Brown University (1984); Ph.D., Harvard University (1990)

### ► Selected Publications

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 Law & Economics*



PAUL HARRISMAN

**RF**

# Urban Entrepreneurs

## The Origins of Black Business Districts in Durham, Richmond, and Washington, D.C.

BY CHARLES GERENA

Jackson Ward was the place to be for African Americans in postbellum Richmond, Va. On 2nd Street, or “the Deuce” as it was known, residents and out-of-towners filled shops during the day, while music from jazz clubs filled the air at night.

From the late 19th century to the mid-20th century, a similar snapshot could be taken in Durham, N.C., or Washington, D.C. As racial segregation and terrorism plagued the South, black business districts in these cities emerged as refuges where African Americans could shop or start businesses of their own. They also served as repositories of much-needed capital for black entrepreneurs and homeowners. Black business districts thrived until the latter half of the 20th century, when desegregation made them less vital to African American consumers.

During the heyday of black business districts, entrepreneurs were both constrained and protected, says William Darity Jr., an economist at the University of North Carolina at Chapel Hill. They were “constrained

in the sense that, to a large extent, black entrepreneurs would have to provide their services to other members of the black community. But [they were] protected in the sense that they were not confronted with significant competition from nonblack businesses.”

The seeds of black commerce were germinating as far back as the 17th century, well before places like Jackson

Ward reached their zenith. “Ninety percent of blacks in the United States were the legal property of other folks, so the extent to which they could engage in entrepreneurial activity depended upon the discretion of their owners,” says Darity. Yet slaves found ways to participate in the economy.

For example, some plantation slaves who grew their own food were allowed to barter or sell their surplus production. Rice, tobacco, and other crops changed hands with other slaves, the slave’s owner, and customers in neighboring plantations and towns. (In the latter case, some of the profits usually went to the owner.) Slaves traded other products as well, including poultry, prepared foods, herbal medicines, and handmade goods.

Entrepreneurial activity also originated from slaves with managerial authority at white-owned plantations and businesses. “Often using the freedom that came from managing their owner’s enterprises, slave entrepreneurs made money by surreptitiously selling their skills and services or their owner’s goods to customers,” wrote historian Juliet E.K. Walker in her 1998 book *The History of Black Business in America*. “In some instances, owners gave their approval to such business activities, as long as the slave managers continued to produce profits.”

It was common for slaveholders to profit from hiring out their laborers. Some slaves recognized their value on the open market and asked to negotiate the terms of their self-employment. Occasionally, they went a step further and asked for permission to run a business. Owners usually acquiesced when they got a cut of the take.



BLACK HISTORY MUSEUM & CULTURAL CENTER OF VIRGINIA

*In addition to showing feature-length films, Richmond’s Hippodrome Theatre showcased Cab Calloway, Nat King Cole, Billie Holliday, Lena Horne, and other black performers.*

What happened to all of this income? Slaves used it to purchase land and other assets. Even as Maryland, Virginia, North Carolina, and other southern states imposed new legal constraints on blacks during the 18th and early 19th centuries, African Americans managed to retain some property rights.

During this period, some blacks accumulated enough wealth to buy freedom for themselves and their families. Free blacks and those born outside of slavery eagerly continued a tradition of entrepreneurship. They found a variety of niches where their skills were valued by whites, including catering and other food services, personal services such as tailoring and hair care, and small-scale manufacturing. A few blacks managed to build substantial enterprises, particularly those that served both whites and blacks, and entered professions like law and dentistry.

Feeling threatened, protectionist whites barred blacks from certain occupations. For instance, in 1836, Washington, D.C., made it illegal for free blacks or slaves to sell alcoholic beverages or run other types of businesses for profit. This added to the challenges of collecting debts and obtaining credit that often impeded the growth of black-owned businesses.

In an effort to address the need for credit, wealthy antebellum blacks acted as informal bankers. They collected other people's savings, then used the funds to make loans and discount bank notes.

African Americans were accustomed to pooling their resources. Throughout the 1600s, slaves secretly formed burial societies to pay for traditional African funerals. Later, mutual aid societies and church-based relief societies used membership fees to offer death benefits, education and vocational training for youths, and other assistance. Some organizations, such as the Brown Fellowship Society in Charleston, S.C., financed start-up businesses.

**W**ith the end of the Civil War in 1865, African Americans thought they finally had a

chance to fully participate in the economy.

Certainly, southern whites had to swallow their resentment and resistance of black commerce to get through Reconstruction. Noted Walker, "They had no alternative but to rely on blacks, who constituted one-third of the South's population, to provide the essential goods and services needed for the...redevelopment of the region."

Yet they tried to maintain the second-class status of blacks whenever possible. Several states enacted "black codes" to keep African Americans out of occupations that could lead to independent enterprises. For example, South Carolina required blacks to obtain a license to participate in any business activity other than farming or domestic service. The catch was that a license couldn't be issued unless a white person provided evidence of the black applicant's good character.

By the turn of the century, southern blacks had lost much of their legal and civil rights. An array of state and local statutes known as Jim Crow laws institutionalized the segregation of whites and blacks. The Supreme Court upheld the creation of "separate but equal" public facilities for each race in 1896.

The result was that black-owned businesses lost their white clientele and black consumers were robbed of places to buy goods and services, forcing them to rely on trading with each other. This "economic detour" put African American commerce on a separate path from the rest of the U.S. economy.

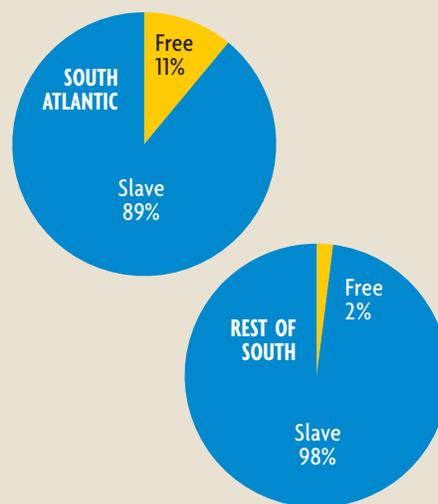
John Sibley Butler, a professor of sociology and management at the University of Texas at Austin, outlined this phenomenon in a 1991 history of black entrepreneurship. "Governmental programs forced Afro-American business people to develop separate enterprises and to sell in a restricted race market. This [had] the effect of decreasing the total amount of business activity among Afro-Americans. Other ethnic groups [were] free to operate in the larger market," thus giving them an advantage that blacks lacked.

Echoing their history of self-help and cooperation, blacks formed benevolent

## Relative Freedom

In the pre-Civil War era, entrepreneurial activity tended to be higher among free blacks than slaves. This could explain why blacks in the rest of the South were drawn to black business districts in the South Atlantic region, which had a higher percentage and number of free blacks.

Black Population, 1860



	South Atlantic	Rest of South
Free	217,753	40,593
Slave	1,840,445	1,998,320

NOTE: As defined by the U.S. Census Bureau, the South Atlantic Division encompasses the Fifth District plus Delaware, Georgia, and Florida. The "Rest of the South" includes the East South Central Division (Ky., Tenn., Ala., Miss.) and the West South Central Division (Ark., La., Okla., Texas).

SOURCE: U.S. Census Bureau

societies and fraternal orders. At first, these groups provided basic necessities for newly emancipated slaves and their families. Later, they provided financial services that were unavailable to blacks at many white-owned institutions.

Blacks also organized building and loan associations when they had problems constructing and buying homes. Several associations were founded in Baltimore and, by 1898, 17 organizations were operating in Maryland, the District of Columbia, Virginia, and five other states.

European immigrants founded similar self-help organizations when they first came to America, but Butler argued that they existed in a different historical context. "No other racial or

## A Symbiotic Relationship

With the reconstruction of the South after the Civil War came new opportunities for African Americans to make money, until segregation reared its ugly head toward the end of the 19th century. The race-specific business districts that subsequently developed contributed to the expansion of historically black colleges and universities (HBCUs), and vice versa.

Most HBCUs were backed by white and black religious organizations in the North that wanted to provide a college-level education to southern blacks who didn't have access to it.

These groups included the African Methodist Episcopal Church, which founded Allen University in Columbia, S.C., and the American Baptist Home Mission Society, which started the antecedent of Virginia Union University in Richmond, Va. The federal Freedman's Bureau, established to help newly emancipated slaves, supported their efforts from 1865 to 1872.

Several universities also benefited from the generosity of neighboring black business districts. James Shepard, a registered pharmacist and businessman, founded North Carolina Central University in 1910 after helping to start Mechanics and Farmers Bank and other institutions in Durham's Hayti and Parrish Street districts. Shepard kept N.C. Central afloat with a combination of private funds and tuition money until the state government purchased the school in 1923.

In turn, HBCUs benefited black business districts by serving as a training ground for future business leaders. Milton Holland, a graduate from Howard University in Washington, D.C., founded Alpha Life Insurance Company near the campus. HBCUs also served as magnets for African-American professionals and intellectuals.

—CHARLES GERENA

tained the masses, numerous black-owned financial institutions in Jackson Ward harnessed the economic power of residents. They included St. Luke Penny Savings Bank, the first bank managed by a black female president, Maggie Walker; and Southern Aid Life Insurance, one of the South's largest black insurers.

About 150 miles south of Richmond, Hayti became Durham's center of black commerce. Many small businesses operated in this neighborhood, while professionals and businessmen settled on Fayetteville Street.

When North Carolina Mutual Life Insurance Company, the nation's largest black-owned insurer, moved from Hayti to Parrish Street in 1906, other financial institutions like Mechanics and Farmers Bank and professional offices opened nearby. By the start of World War II, Parrish Street earned the nickname of "Black Wall Street."

While Hayti and Parrish Street had much in common with Jackson Ward, there were some important distinctions. First, Durham wasn't an old southern city entrenched in a history of racial and class-based separation. It was sparsely populated by farmers until the railroad came through in 1853. Tobacco warehouses sprung up along the tracks, creating demand for black and white laborers.

"My hunch is that the growth was so rapid that anybody could come here to get a job," says Perry Pike, education coordinator for the Historic Preservation Society of Durham. "They couldn't afford to discriminate in the way that other southern cities did."

Second, while blacks lived separately in Hayti and a few other communities, Durham was relatively progressive. "You saw a difference here," says Andre Vann, an official at North Carolina Central University who co-authored a book called *Durham's Hayti*. He believes there was more cooperation between blacks and whites in Durham than in other southern cities. "Many white capitalists used the black-owned banks to funnel their money [into black communities] inconspicuously."



*Howard University was the center of black business and cultural activity in Washington, D.C., following the Civil War.*

ethnic group... has had to face the total constitutionally sanctioned exclusion from the larger society that Afro-Americans have experienced. ...In an environment that totally shut them out, Afro-Americans placed more emphasis on self-help."

One of the prominent self-help organizations for blacks in the Fifth District was the Grand Fountain United Order of True Reformers, founded in Richmond's Jackson Ward by the Rev. William Washington Browne in 1881. In addition to providing financial services through its insurance company and bank, True Reformers used its members' funds to operate a chain of department stores, a newspaper, and a home for the elderly. It also invested in real estate in 10 Virginia cities, Washington, Baltimore, and other locations.

While some of these institutions lasted only a few decades, they all supported new business development and home ownership among blacks. These

were two important ingredients for blacks to survive independently in rural and urban areas throughout the South.

Most of this economic activity took place within black-only communities, since segregation prevented African Americans from buying land or conducting business in white communities. In southern cities, black businesses and professionals were pushed into race-specific districts, often relegated to the outskirts of the busy Main Streets where they once served all races.

Jackson Ward was one of these communities. German, Italian, and Jewish immigrants, who settled the area from the late 1700s to the mid-1800s, lived side by side with free and enslaved blacks. Once segregation divided Richmond by the end of the 19th century, however, Jackson Ward became the city's center of black commerce.

A few blocks from where Duke Ellington and Cab Calloway enter-

Richmond was also considered a fairly progressive city. "It was a gateway to the...North," says Charles Bethea, executive director of the Black History Museum and Cultural Center of Virginia. "Jim Crow segregation was very harsh throughout all of the South," but changed the farther north you went. "Let me put it this way: There were more civil rights cases filed in Virginia than anywhere else, pre- and post-Civil War."

Farther north, in Washington, D.C., a large number of well-educated, free blacks asserted their political and economic power in the face of antebellum racism. During the 1860s, racial discrimination in restaurants, hotels, and other public places became illegal, and blacks won the right to vote and receive public schooling. The city reportedly had the nation's largest urban black population.

But in the following decades, Washington became increasingly hostile toward blacks and rigidly segregated. The growth of public transportation enabled whites to exit middle-class communities like Shaw and move into new developments that were closed to other races, leaving blacks behind. At the same time, black businessmen were forced out of downtown Washington and relocated to U Street, 7th Street, and 14th Street N.W. in Shaw.

By 1910, Shaw had more than 200 black-owned businesses offering everything from jewelry to printing services. The Order of True Reformers built a five-story building on 12th and U streets to house the Washington branch of its bank, a concert hall, and offices for black professionals. The rest of U Street became a business and entertainment corridor for Washington's black community, while 7th and 14th streets evolved into retail corridors for blacks that migrated from rural areas after World War I.

Eventually, though, black business districts lost working-class blacks who became fed up with repressive Jim Crow laws and moved north, where social conditions seemed better and

factory jobs were abundant. But middle and upper class blacks had no reason to leave the business districts where they had set down roots. They felt somewhat sheltered from the racial tensions of the South, especially those who were in the good graces of the white establishment and had their financial backing.

By the 1950s and 1960s, however, black business districts began to decline for other reasons. Historians believe that desegregation and the social progress of blacks created a new economic reality for these districts.

As black consumers ventured into the white business community, black business districts faced new competition. "The Civil Rights Act of 1964 didn't make all public accommodations open overnight," says Darity. "But over time, blacks had a much greater reach of potential service providers."

Butler at the University of Texas agrees with this assessment, adding that young blacks didn't want to run their family businesses because they thought they could make more money elsewhere. "[My family] had three malt shops and I managed them by the time I was 16. I wanted nothing to do with it when I became a man."

Urban renewal efforts in later decades attempted to revitalize black business districts, but they often backfired. In Jackson Ward and Hayti, the construction of a highway led to the destruction of distinctive historic structures and isolated black communities. Jackson Ward lost more of its historic real estate from the construction of the Richmond Coliseum and the convention center.

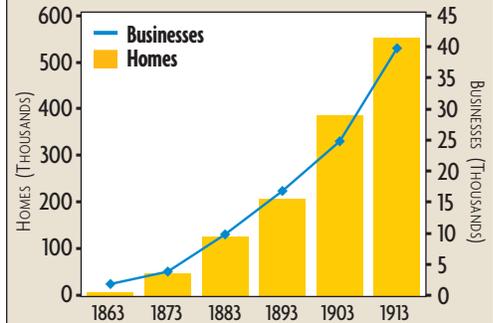
Private redevelopment has occurred in black business districts as well. For example, upscale shops and loft apartments are being developed on 14th Street in Shaw, which was decimated when riots burned black communities throughout Washington in 1968.

Some would say that these private and public revitalization efforts are part of a "systematic, political dismantling" of black communities, as Darity puts it. Others see it in a more positive light, as an example of "creative destruction"

## Progress Against The Odds

Business and home ownership among African Americans continued to rise after the Civil War ended in 1865, despite social and legal discrimination. Black-owned financial institutions get some of the credit for keeping money flowing during this challenging period.

### Black-Owned Properties



SOURCE: "Negro Year Book: An Annual Encyclopedia of the Negro, 1914-1915," Tuskegee, Ala.; Negro Year Book Publishing Company, 1915

that ultimately will yield large benefits.

However one views this transformation process, though, it seems likely that these areas' rich histories will be preserved in some form. Cultural Tourism D.C. is marketing Shaw as the South's version of Harlem, while private interests in Jackson Ward envision an entertainment district that could serve visitors to the Greater Richmond Convention Center. **RF**

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Butler, John S. *Entrepreneurship and Self-Help Among Black Americans: A Reconsideration of Race and Economics*. Albany: State University of New York Press, 1991.

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Vann, Andre D. and Beverly W. Jones. *Durham's Hayti*. Charleston, S.C.: Arcadia Publishing, 1999.

Walker, Juliet E.K. *The History of Black Business in America: Capitalism, Race, Entrepreneurship*. New York: MacMillan Library Reference USA, 1998.

Visit [www.rich.frb.org/pubs/regionfocus](http://www.rich.frb.org/pubs/regionfocus) for links to relevant Web sites.

# District Economic

BY ROBERT LACY

**Economic growth accelerated in the Fifth District in the third quarter of 2003. Sales growth was faster at the District's retail and services establishments and housing activity remained stalwart, despite rising mortgage interest rates during much of the quarter. But not all economic data were so encouraging: Employment numbers continued to disappoint and manufacturing output drifted lower.**

## Did You Know. . .

There are 1.2 million recreational boats in the Fifth District—382,072 in South Carolina alone, according to the National Marine Manufacturers Association. On a per capita basis, the Palmetto State ranks 5th in the country in boat ownership. Its 187 miles of Atlantic Ocean shoreline and large and plentiful manmade lakes provide ample opportunity to get out on the water.

Economic growth in the Fifth District picked up in the third quarter of 2003. The sluggish expansion of spring gave way to solid economic growth by July. District retailers and services providers in particular reported much higher revenues during the period. Hurricane Isabel, which swept through the District in September, disrupted retail and services businesses in some areas but fortunately had few long-lasting impacts on the region's economy.

A few clouds lingered, however, in this generally brighter economic picture. Most notably, the Fifth District's manufacturing sector remained in the doldrums. And, while sales at most District businesses rose at a brisk pace, many employers were very cautious in hiring. We still await a turn in employment numbers that would confirm the District's economy is on solid footing.

## Services and Retail Busting Out

The District's broad services sector expanded at a rapid pace in the third quarter. Retailers said revenues grew much more quickly—the sales index from our survey of retailers showed the largest average quarterly gain in three years. Services businesses generally reported relatively strong sales as well, likely boosted by higher disposable income from federal tax cuts.

District realtors tell us that home sales remained strong in the third quarter, despite a modest rise in mortgage interest rates in July and August. In fact, several realtors said the

uptick in interest rates had spurred home sales in recent months as fence sitters committed to home purchases in anticipation of further rate hikes. By the end of the third quarter, mortgage rates had edged lower, and realtors were continuing to report robust home sales with 30-year mortgage rates generally below 6 percent.

## Manufacturing Drifts

The District's manufacturing sector contracted modestly in the third quarter, in large part because of the ongoing decline of the textiles and apparel industry in the region. Manufacturing shipments and new orders moved lower and employment in the sector shrank.

Hurricane Isabel caused some manufacturing operations to shut down for a few days, but there were relatively few long-term economic consequences from the storm. Lumber mill operators reported some of the most extensive disruptions—those with timber holdings said that timber supplies would be lower for some time to come because of extensive wind damage.

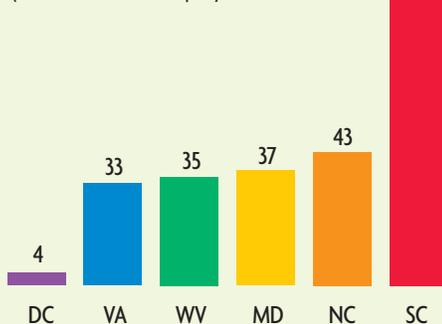
## You Hiring Yet?

Although many business contacts tell us their sales are improving, relatively few say they have stepped up hiring. Overall payroll employment in the District fell by 0.2 percent in the third quarter compared to a year ago. Jobs in the beleaguered manufacturing sector have declined by 4.8 percent over the last year. But employment gains were reported in the District's broad services-providing sector—jobs there were up 0.4 percent in the third quarter.

## Personal Income Growth Modest

Personal income in Fifth District states rose a modest 3.2 percent in the second quarter of 2003. Substantial differences in earnings growth were recorded by sector, however. Earnings in the retail sector, for example, grew by only 1.2 percent while those in manufacturing declined by 1.2 percent. In contrast, earnings in the District's flourishing health care industry rose by 7.0 percent during the second quarter of 2003.

**Recreational Boats**  
(Per Thousand People)



# Developments

## Nonfarm Employment Third Quarter 2003

	Employment (Thousands)	% Change (Year Ago)
DC	661	-0.6
MD	2,486	0.9
NC	3,826	-0.3
SC	1,774	-1.9
VA	3,502	0.2
WV	730	-0.2
5th District	12,981	-0.2
US	129,838	-0.3

## Unemployment Rate Percent

	3rd Qtr. 2003	3rd Qtr. 2002
DC	6.6	6.3
MD	4.4	4.3
NC	6.5	6.7
SC	6.5	5.8
VA	3.8	4.0
WV	6.4	6.2
5th District	5.3	5.3
US	6.1	5.8

## Personal Income Second Quarter 2003

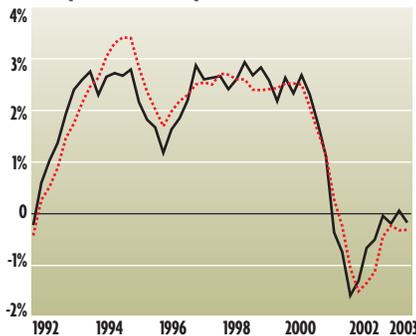
	Income (\$ billions)	% Change (Year Ago)
DC	25.3	2.4
MD	201.9	2.6
NC	237.3	3.7
SC	107.8	3.5
VA	246.1	3.3
WV	43.6	2.7
5th District	862.0	3.2
US	9,156.0	2.7

———— Fifth District

----- United States

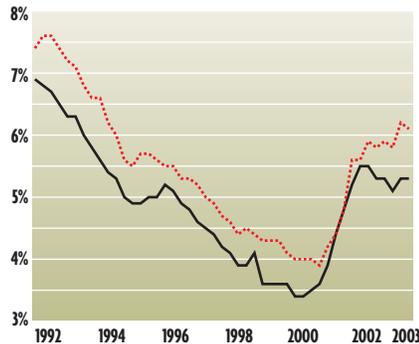
### Nonfarm Employment Change From Prior Year

First Quarter 1992 - Third Quarter 2003



### Unemployment Rate

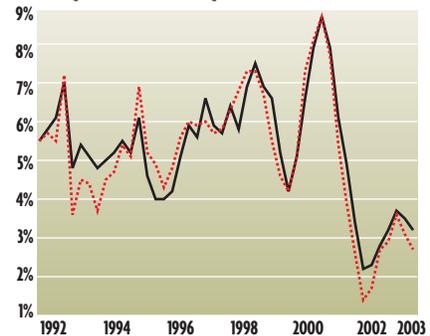
First Quarter 1992 - Third Quarter 2003



### Personal Income

Change From Prior Year

First Quarter 1992 - Second Quarter 2003



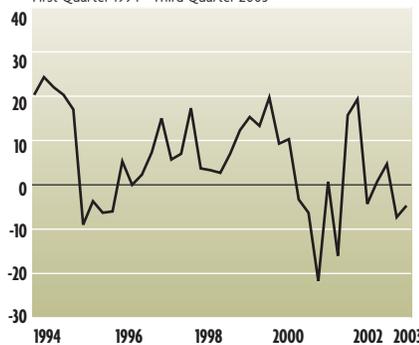
### FRB—Richmond Services Revenues Index

First Quarter 1994 - Third Quarter 2003



### FRB—Richmond Manufacturing Shipments Index

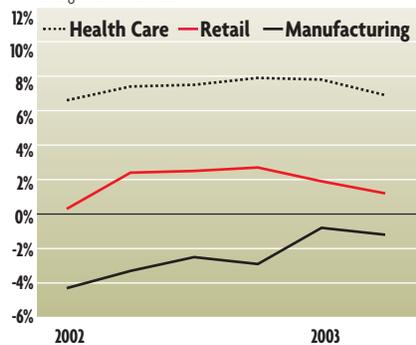
First Quarter 1994 - Third Quarter 2003



### Earnings by Selected Industry

Fifth District

Change From Prior Year



#### 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>

For more information, contact Robert Lacy at 804-697-8703 or e-mail [Robert.Lacy@rich.frb.org](mailto:Robert.Lacy@rich.frb.org).



# DISTRICT OF COLUMBIA

BY ANDREA HOLLAND

Recent economic data for the District of Columbia have been mixed. Indicators of household activity were positive across the board, but business conditions have yet to perk up.

Payroll employment numbers nosed down again in the third quarter, but losses were largely seasonal. The number of job seekers rose for the third straight quarter and the number of unemployed persons declined 8.0 percent — pushing the jobless rate down by 0.2 percentage points. Additional support for a firmer labor market was found in the Richmond Fed's October Beige Book entry. Executive search firms in the Washington area reported an increase in demand for their services.

Income measures also improved in Washington recently. Second quarter personal income growth was 0.6 percent higher than in the second quarter of 2002, marking the sixth consecutive quarter of expansion. Of the industries posting income gains, the largest increases were recorded in construction.

But gains in construction earnings may slow going forward — third quarter new housing permits were significantly weaker over the year and over the quarter, suggesting the possibility of cooling in housing construction. The market for existing homes, however, continued to forge ahead in the third quarter. Despite rising interest rates, existing home sales outpaced levels recorded a year ago by 19.9 percent.

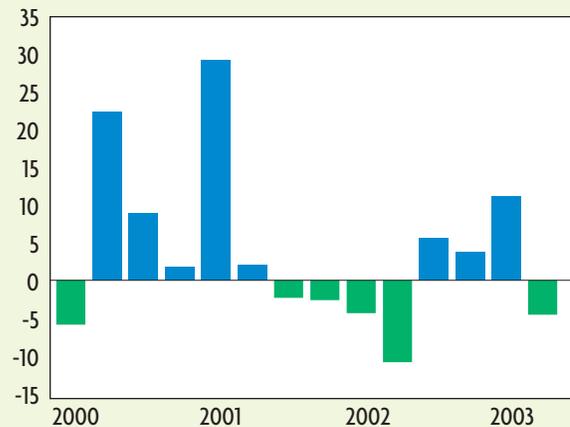
While housing remains relatively strong, measures of commercial real estate remained subdued. Office vacancy rates edged 0.4 percent higher in the third quarter to reach 10.8 percent. Even so, the amount of vacant space in the District of Columbia remains six percentage points below the national rate.

Venture capital investment was significantly lower in the third quarter than in the second quarter. But part of the drop may be because second quarter inflows were unusually high. New funding totaled \$3.6 million and is slotted for the opening of a healthcare services firm.

Turning to fiscal conditions, total tax collections in the second quarter were 4.5 percent lower than a year earlier, but came on the heels of three consecutive quarters of growth. Losses were recorded in both personal income and sales tax collections, while corporate tax revenues continued to rise.

## DC Total Tax Collections

Percent Change From Prior Year



SOURCE: U.S. Census Bureau

	Percent Change at Annual Rate From		
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Nonfarm Employment	660.9	-1.1	-0.6
Manufacturing, NSA	2.8	0.0	-8.7
Professional/Business Services	141.2	0.5	0.7
Information	25.7	-2.0	1.0
Civilian Labor Force	310.3	3.6	2.5
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Unemployment Rate	6.6	6.8	6.3
Building Permits, NSA	182	539	1,045
Home Sales	16.3	14.7	13.6

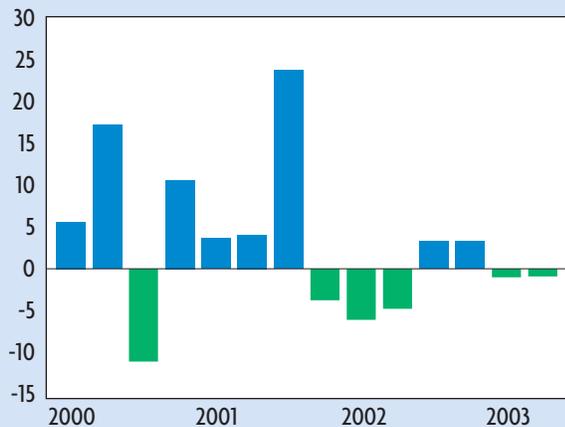
NOTES:  
 Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics  
 Manufacturing, thousands of jobs, not seasonally adjusted (NSA); BLS/Haver Analytics  
 Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics  
 Information,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



BY ANDREA HOLLAND

## MD Total Tax Collections

Percent Change From Prior Year



SOURCE: U.S. Census Bureau

	Percent Change at Annual Rate From		
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Nonfarm Employment	2,486.4	-1.1	0.9
Manufacturing	152.3	-3.8	-2.0
Professional/Business Services	363.0	-3.5	0.8
Information	50.5	-3.1	-3.6
Civilian Labor Force	2,922.5	-1.5	0.7
Unemployment Rate	4.4	4.4	4.3
Building Permits, NSA	6,602	8,849	7,289
Home Sales	140.7	124.3	124.2

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  
 Information, thousands of jobs, SA; BLS/Haver Analytics  
 Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics  
 Unemployment Rate, percent, SA; BLS/Haver Analytics  
 Building Permits, number of permits, not seasonally adjusted (NSA); U.S. Census Bureau/Haver Analytics  
 Home Sales, thousands of units, SA; National Association of Realtors®

The latest data suggest continuing pockets of weakness within Maryland's households and firms. Labor market activity and fiscal conditions in Maryland remain the weakest links.

In the third quarter, Maryland firms trimmed payrolls by 1.1 percent. Employment losses reached across most sectors, with only the leisure and hospitality industry recording job gains. Third quarter household data also suggested generally flat labor market conditions. The number of labor force participants decreased for the first time since 2000, but the number of unemployed persons declined as well, keeping the jobless rate unchanged at 4.4 percent.

But recent anecdotal information has been more upbeat. According to the Richmond Fed's October Beige Book entry, a contact at a Baltimore financial services firm reported that customer demand was strong enough to warrant an increase in hiring in the third quarter. Also in the report, a temporary employment agency in Hagerstown noted an upturn in demand for workers.

Venture capital investment activity in Maryland steadied in the third quarter. By stage of investment, expansion funding accounted for half of total inflows, while startup funding accounted for nearly a quarter. Montgomery County received the most funds, followed closely by Prince George's County. Internet-related technology accounted for more than one-third of total investment.

The news is mixed on the state's fiscal situation. Despite an uptick in the formation of new firms, corporate and sales tax collections did not rise enough to offset large losses in personal income tax collections in the second quarter.

In contrast to weaker individual income collections, second quarter personal income growth was 0.8 percent higher than 12 months before. Earnings were higher in most sectors, but manufacturing and information sector earnings softened.

The news in real estate was generally positive. Third quarter existing home sales broke a new record in Maryland, rising 13.3 percent over the year. But in contrast, building permits were below levels recorded a year ago. Baltimore's commercial real estate market seems to have stabilized. The vacancy rate has held steady at 14.7 percent since the beginning of 2003.



# NORTH CAROLINA

BY ANDREA HOLLAND

The most recent information suggests that household and business conditions in North Carolina are firming, but overall economic activity in the state continues to be held back by a weak labor market.

But job seekers in North Carolina may have reason for optimism. After declining continually throughout 2002, North Carolina's civilian labor force has grown steadily in 2003. The inflow of labor market participants continued in the third quarter, edging 0.5 percent higher. At the same time, the number of unemployed persons rose 7.2 percent — nudging the jobless rate up 0.1 percentage points to 6.5 percent.

Third quarter North Carolina payrolls fell by 1.6 percent. The decline follows two quarters of positive job growth. Factory employment was again battered in the state, declining an additional 7.9 percent.

Continued weakness in the manufacturing sector also has eroded factory earnings — the second quarter data decline was the tenth straight. But on a brighter note, earnings were higher in almost all other industry sectors, boosting North Carolina's total personal income.

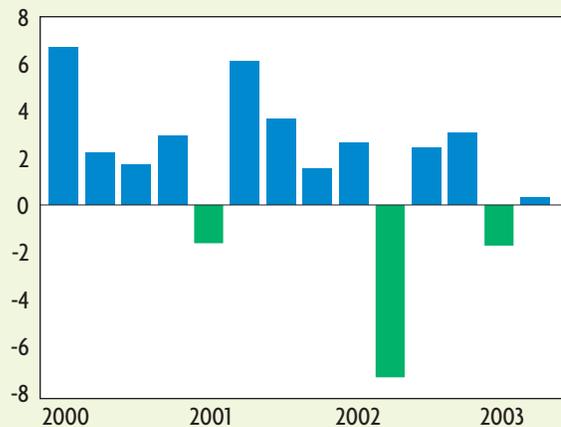
Despite rising personal incomes, hefty and ongoing losses in sales and personal income tax collections were recorded in the second quarter. Still, total tax collections advanced compared to the second quarter of 2002 thanks to strong corporate tax receipts.

Turning to real estate, existing home sales in the third quarter reached an all time high — coming in 26.7 percent above last year's level. In addition, new building permits were above the year-earlier level. But not all real estate news was rosy. Commercial real estate conditions continued to deteriorate in Charlotte. Vacancy rates shot up 0.6 percentage points in the third quarter, the largest quarter-to-quarter gain in the Fifth District.

In other business news, venture capital investment into North Carolina firms edged down slightly in the third quarter. Venture capital totaling \$99 million was infused into 14 companies statewide. Four biotechnology firms and one Internet-related technology firm received nearly 60 percent of the total inflows. By investment stage, expansion funding accounted for nearly 70 percent of all inflows, while the share of startup funding totaled only 6 percent. Counties receiving the most funding included Wake, Chatham, Durham, Mecklenburg, and Guilford.

## NC Total Tax Collections

Percent Change From Prior Year



SOURCE: U.S. Census Bureau

	Percent Change at Annual Rate From		
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Nonfarm Employment	3,826.5	-1.6	-0.3
Manufacturing	603.7	-7.9	-5.3
Professional/Business Services	427.2	4.4	1.7
Information	79.7	3.6	-2.1
Civilian Labor Force	4,174.3	0.5	0.4
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Unemployment Rate	6.5	6.4	6.7
Building Permits, NSA	20,761	20,776	20,092
Home Sales	314.0	266.8	247.9

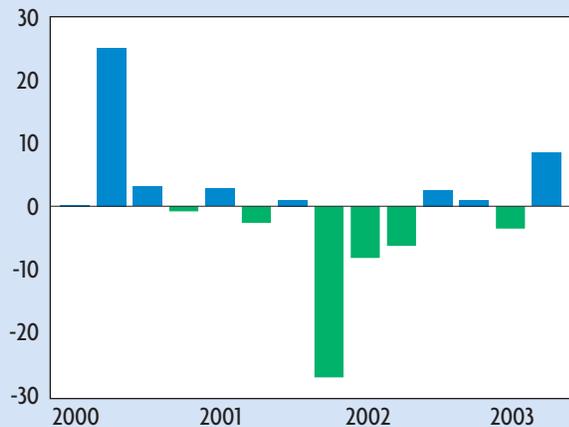
NOTES:  
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics  
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics  
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics  
Information, thousands of jobs, SA; BLS/Haver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



BY ANDREA HOLLAND

## SC Total Tax Collections

Percent Change From Prior Year



SOURCE: U.S. Census Bureau

	Percent Change at Annual Rate From		
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Nonfarm Employment	1,774.5	-3.3	-1.9
Manufacturing, NSA	273.8	-7.5	-6.2
Professional/Business Services, NSA	178.7	2.7	-2.8
Information, NSA	27.8	2.9	1.0
Civilian Labor Force	2,027.7	-0.1	2.8
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Unemployment Rate	6.5	6.3	5.8
Housing Permits, NSA	9,703	9,471	7,930
Home Sales	155.3	132.6	122.1

**NOTES:**

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

Prospects for a rebound in economic activity in South Carolina firms and households appear somewhat brighter, but labor market conditions must improve to ensure an upturn.

Nonfarm payrolls at South Carolina establishments continued their downward slide in the third quarter. Job numbers fell by an additional 3.3 percent, marking the third straight quarter of contraction. News was no brighter at South Carolina households. The civilian labor force backpedaled 0.1 percent and the number of unemployed persons rose 13.3 percent, kicking the jobless rate up 0.2 percentage points to reach 6.5 percent in the third quarter.

Outside of the labor market, however, indications of improvement were more apparent. At 1.7 percent, personal income growth in the 12 months leading up to the second quarter in South Carolina outpaced all but one Fifth District jurisdiction. In line with the solid expansion in personal income, earnings were also mostly positive, including a second straight uptick in factory earnings.

The news on real estate was all positive. The number of new building permits authorized outpaced levels recorded a year ago, and according to the Fifth District's October Beige Book entry a commercial realtor in Columbia was "cautiously optimistic" regarding activity for the remainder of the year. The best news, however, was that compared to last year, third quarter home sales were 27.2 percent higher—outpacing growth in each Fifth District jurisdiction and the nation.

South Carolina also surpassed other Fifth District states in certain fiscal indicators in the second quarter. Total tax collections were 8.4 percent higher from the second quarter of 2002 through the second quarter of 2003, easily exceeding collections in other Fifth District states. The overall gain occurred as large sales tax collections outweighed small losses in individual income and corporate tax collections.

Third quarter venture capital investment in South Carolina totaled \$26.1 million—the highest level recorded in two years. An expanding consumer product and services firm in Florence County received \$25 million, and another \$1.1 million helped finance the expansion of a financial services business in Richland County.



# VIRGINIA

BY ANDREA HOLLAND

The latest economic data suggest that indicators of household activity in Virginia may have turned a corner, but business conditions have yet to bounce back.

According to the Bureau of Labor Statistics (BLS) household survey, for the third quarter, Virginia's jobless rate fell to 3.8 percent—the lowest in the Fifth District. But business hiring in the state was less robust—the BLS establishment survey recorded slightly negative payroll activity in the third quarter.

In line with sluggish labor market conditions, venture capital activity declined again in the third quarter. In fact, Virginia inflows were the lowest on record since 1996. Twelve companies received funding, with six Internet technology-related business accounting for nearly half of all capital.

By investment stage, startup funding accounted for nearly 35 percent of all inflows, followed closely by later and early stage investment at 26 and 27 percent, respectively. Areas receiving funding included Fairfax County, Loudoun County, Manassas, and Norfolk.

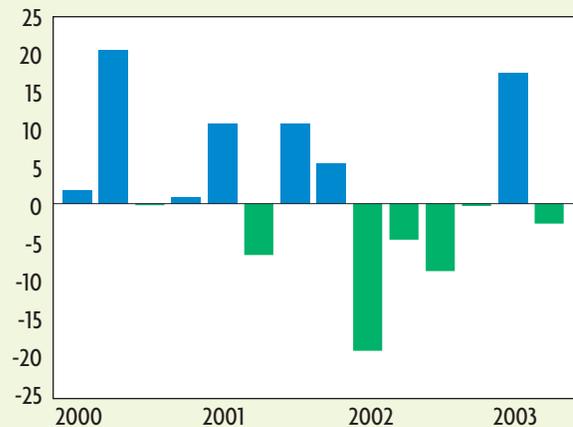
Fiscal conditions remain weak for Virginia's government. After posting strong gains in the first quarter, second quarter tax collections in Virginia contracted over the year. Losses in individual income and corporate collections could not offset small gains in sales tax collections.

Turning to households, second quarter personal income growth was 1.5 percent higher over the year, outpacing the national growth rate. Earnings expanded in all sectors, except manufacturing; transportation and warehousing; information; and arts, entertainment, and recreation. By industry, the largest expansion was recorded in finance and insurance, resulting partly from a booming real estate market.

The real estate sector posted strong gains. The number of existing homes sold in Virginia in the third quarter set a new record. Turning to commercial real estate conditions in Northern Virginia, although available office space still exceeded needed space in the third quarter, some signs of improvement emerged. Most notably, vacancy rates moved lower and net absorption inched higher compared to the second quarter.

## VA Total Tax Collections

Percent Change From Prior Year



SOURCE: U.S. Census Bureau

	Percent Change at Annual Rate From		
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Nonfarm Employment	3,502.1	-0.3	0.2
Manufacturing	306.1	-4.5	-3.8
Professional/Business Services	550.8	0.8	0.8
Information	100.3	-1.8	-2.9
Civilian Labor Force	3,795.0	-0.1	1.6
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Unemployment Rate	3.8	4.0	4.0
Housing Permits, NSA	14,230	15,801	15,038
Home Sales	180.1	170.6	156.5

NOTES:

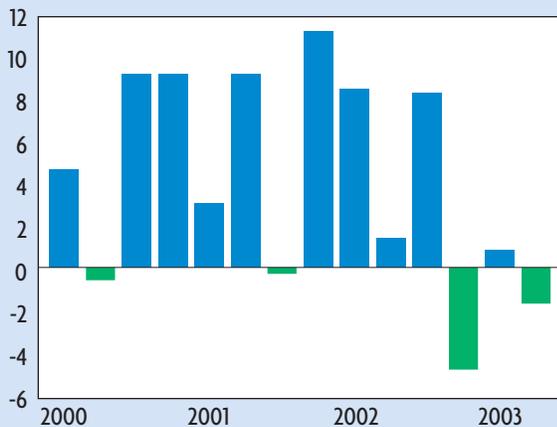
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics  
 Manufacturing, thousands of jobs, SA; BLS/Haver Analytics  
 Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics  
 Information, thousands of jobs, SA; BLS/Haver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



BY ANDREA HOLLAND

## WV Total Tax Collections

Percent Change From Prior Year



SOURCE: U.S. Census Bureau

Recent measures of household and firm activity in West Virginia suggest that the economic environment remains spotty, with payroll conditions continuing to constrain any significant gains in overall economic activity.

West Virginia payroll employment numbers retreated again in the third quarter. The number of unemployed persons at households shot up 24 percent, pushing the jobless rate up 0.3 percentage points to 6.4 percent—the highest quarterly unemployment rate since 1999.

Despite continued layoffs, income measures improved in the state. Second quarter personal income growth was 0.9 percent higher than in the second quarter of 2002. Over the year, earnings expanded in all industries, except for construction; manufacturing; wholesale trade; management of companies and enterprises; and administrative and waste services. The largest decline in earnings was recorded in the construction industry.

Looking ahead, construction earnings may not be poised for rapid improvement. Third quarter new building permits were lower than levels recorded the previous quarter as well as the same period last year. Sales of existing housing units, however, forged ahead in the third quarter, outpacing levels recorded a year ago by 19.1 percent.

In other economic news, third quarter venture capital investment matched second quarter levels in West Virginia. New funding totaled \$8 million, with all but \$0.6 million going toward the later stage expansion of an Internet technology firm in Berkeley County. The remaining inflows are slated to be evenly divided between two firms, one in Monongalia County and the other in Putnam County.

The state's fiscal condition remains weak. Total tax collections in the Mountain State during the second quarter were 9.2 percent lower than the year before. Individual and corporate tax receipts were both lower, while sales tax revenues continued to rise.

	Percent Change at Annual Rate From		
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Nonfarm Employment	730.3	-0.7	-0.2
Manufacturing	65.6	-2.6	-4.2
Professional/Business Services	58.8	-5.0	2.6
Information, NSA	12.8	-2.1	-3.5
Civilian Labor Force	805.5	1.0	0.6
	3rd Qtr 2003	2nd Qtr 2003	3rd Qtr 2002
Unemployment Rate	6.4	6.1	6.2
Building Permits, NSA	1,291	1,315	1,132
Home Sales	33.6	24.7	28.2

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

For more information regarding state summaries, call 804-697-8273 or e-mail [Andrea.Holland@rich.frb.org](mailto:Andrea.Holland@rich.frb.org).

## Is Greenspan a Wicksellian?

BY THOMAS M. HUMPHREY

Sir Isaac Newton's remark about seeing farther because he stood on the shoulders of giants also applies to central bankers. The latter stand on the shoulders of Knut Wicksell, a Swedish economist who in 1898 advanced the policy-analysis prototype that central bankers have been using ever since. It was Wicksell who first showed that inflation and deflation result when the central bank sets its interest rate at the wrong level—and that it can stabilize prices through judicious adjustment of the rate.

Some have alleged that Federal Reserve Chairman Alan Greenspan is a Wicksellian because he implicitly targets the economy's natural rate of interest. This reasoning is suspect. Greenspan has never indicated that he targets the natural rate. And Wicksell himself denied that the unseen natural rate could be targeted. Instead, he thought central bankers should target the price level because it is observable and because its deviations from target indicated corresponding deviations of market interest rates from the unseen natural rate.

Are there other, valid grounds to believe that the Federal Reserve is Wicksellian? To answer that, let's reverse the question and ask if Wicksell would see his beliefs embodied in recent Federal Reserve policy. The evidence is mixed at best.

On the yes side is Wicksell's understanding of rational expectations, a concept he employed after World War I to claim that a pre-announced and fully anticipated deflation would not affect real activity. All central bankers are Wicksellians now in believing that credibility and rational expectations in a flexible-price economy are capable of rendering systematic monetary policy neutral in its real effects. Equally, they believe that unpredictable, random policy would have painful real effects. It would drive the economy away from the growth path depicted in real business cycle (RBC) models.

Against these similarities are at least three differences. First, Wicksell defined price stability as absolute constancy of the price level. The Fed, by contrast, typically defines it as a rate of inflation so low as to leave business decisionmaking unaffected. Wicksell would complain that this definition trivializes the idea of price stability. Believing that price-level constancy is as important as that of all standard weights and measures, he advocated a government board to determine an unvarying standard price level for the central bank.

Second, in advocating stabilization of the price level rather than merely keeping inflation low, Wicksell offered tradeoffs different from those offered by inflation-targeting central

bankers. Wicksell's price-level targeting yields zero-price drift at the cost of greater price and interest-rate volatility. By contrast, implicit inflation targeting yields less price and interest-rate volatility at the cost of more price drift.

Third, Wicksell rejected the New Economy notion that rapid technological progress and productivity growth ease the central bank's job by holding inflation in check. Wicksell always claimed that such forces, prevalent in his time as they are in ours, influenced relative prices but not the general price level. The latter, in his view, was determined by monetary policy, thus rendering the eradication of inflation and deflation the responsibility of the central bank. The upshot of these differences is that Fed policymakers are Wicksellian only in the broad sense that all modern monetary economists are: They concur with some but not all of Wicksell's views.

The question remains: Would Wicksell, whose analytical frameworks dictated his policy stance, have been a good chairman of the Federal Open Market Committee? Here the key point is that Wicksell's analysis of the relation between money and prices—his famous cumulative process model—was completely divorced from his analysis of business cycles in which fluctuations are seen as driven by real shocks such as technological progress and wars. In one sense,

the mutual exclusivity of real and monetary models is right and correct: When agents have rational expectations and the central bank has credibility, then monetary policy, being entirely neutral, is disconnected from the real sector, which follows the dictates of real business cycle models. If you believe RBCs are optimal—that is, they offer the best dynamic paths along which the economy can grow—then Wicksell's analysis, and the divorce between his money and real models, makes perfect sense. Armed with these models and the policy stances emanating from them, he would have made a good chairman.

On the other hand, if you use sticky-price models, as many central bankers do, to show that money temporarily affects real activity, then Wicksell is wrong. With sticky prices, money and monetary policy affect real as well as nominal variables, making Wicksell obsolete as a policy advisor. Indeed, the message of sticky-price models is that central banks that use their credibility to anchor price expectations also have the flexibility to mitigate slumps in real activity. The Federal Reserve in the Greenspan era has appreciated this. Wicksell arguably did not.

RF

*“Wicksell rejected the New Economy notion that rapid technological progress and productivity growth hold inflation in check.”*

## Who's Paying the Doctor?

Health care is one of the biggest industries in the Fifth District. But it is also one of the least understood. How is health care financed? What role do HMOs play—and are they really the bogeyman that many people believe? Is there a viable alternative to employer-paid health insurance?

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## Clogged Inboxes

E-mail has been a great boon to individuals and businesses by making communication more efficient. But, as with most good things, there are downsides: “spam,” for instance. Recently, the President signed a tough new federal anti-spam bill, which follows on the heels of state-based laws designed to address the problem, including one in Virginia. Will these laws achieve their intended goals? Or will they stifle an important new technology by blocking legitimate messages? More fundamentally, can the market handle the problem of spam on its own?

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## The Economics of Invasive Species

Nearly everyone heard about the snakehead fish that surprisingly appeared in a Maryland pond last year, causing much consternation among local citizens and officials. But there are many other invasive species that have been introduced to the region. For instance, nutrias imported into the United States for their fur have spread rapidly, munching on everything they can find in the wild. And, of course, there is kudzu, which reeks havoc throughout the Southeast. How do we continue to encourage liberalized foreign trade while managing the potential dangers that invasive species can bring from abroad?

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## Tobacco Auctions

Fewer farmers are using decades-old auction markets to sell their golden leaves. Instead, auction houses in Maryland, North Carolina, and Virginia have gradually closed as farmers have signed contracts directly with cigarette makers like Philip Morris. How did the tobacco auction market form? How well did the system function at its peak? And what caused it to fall out of favor?

## Interview

A conversation with Nobel laureate James Buchanan, professor of economics at George Mason University and one of the founders of the “Public Choice” school of economics.

## Jargon Alert

Air pollution is a common example of an “externality.” What are some others, and are externalities always negative?

## Legislative Update

Washington recently added a prescription drug benefit to the Medicare program. What will this mean for seniors—and for pharmaceutical companies?

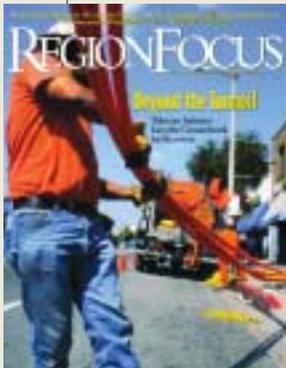
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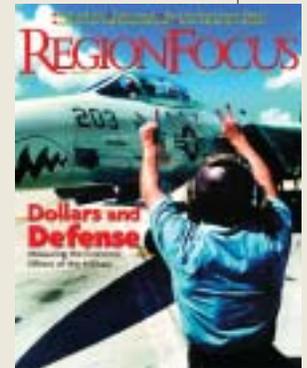
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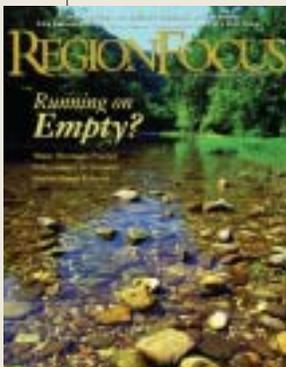
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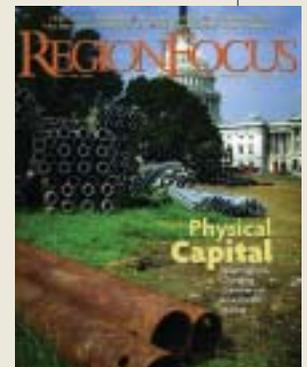
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