SUMMER 2005

REGION FOCUS

THE FEDERAL RESERVE BANK OF RICHMOND

UNDER SCRUTINY

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- Tobacco Buyout
- Bankruptcy Reform
- *Freakonomics*
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Retail Credit Expansion and Regulatory Overreaction

At the turn of the 20th century, working Americans had relatively few attractive options for obtaining credit. Often, they took out loans with high costs and inscrutable terms. Worried about this trend, New Jersey passed the country's first small loan laws in 1914. Like similar measures to follow in other states, the New Jersey legislation included requirements that lenders who charged more than the legal interest rate for banks be licensed and that borrowers be informed about the precise terms of their transaction. More than any other effort in the early 1900s, small loan laws were credited with helping to protect poor borrowers from price gouging.

We have witnessed a similar pattern over the past 100 years. When new forms of retail credit have become available, there has often been a political response, ranging from disclosure rules for installment lenders in the 1920s to curbs on payday advances in the 1990s. Sometimes these responses have been driven by populist aversion to financial institutions; sometimes by sound economic principles. Occasionally, they have been counterproductive.

It is important to remember these lessons of history. The United States is currently experiencing what can arguably be called a revolution in retail consumer finance, one of the greatest credit expansions in history. And with it we are encountering the anticipated policy responses. While in general we would expect that regulations ought to adapt to changing credit market practices, there is a very real danger here of regulatory overstep. It's important to remember that, on the whole, the expansion of retail credit has been tremendously beneficial. Limiting this expansion might have the undesirable effect of preventing the people most in need of credit from obtaining it in the first place.

Over the past 15 years, technological advances have reduced the cost of gathering, processing, and retaining consumer account information. These savings have been passed along to borrowers in the form of lower lending rates. Credit cards, which used to be available almost exclusively at high interest rates, are now offered at lower rates to a broader market of creditworthy customers.

The upshot is that more people today can afford to borrow. Because credit allows people to choose a spending pattern that is smoother over time than their income stream, the expansion of retail credit over the last two decades has yielded positive net benefits for American consumers.

So once again we have an episode of expanding credit accompanied by a regulatory response. Among the most recent measures, North Carolina has enacted legislation that limits certain practices in the subprime market. At the national level, the data that lenders are required to submit under the Home Mortgage Disclosure Act now must include information on interest rates if they exceed a certain spread over funding costs. Some advocates have recently proposed expanding credit card disclosure requirements to include, for example, the time it would take to repay the bill while just making the minimum payments. Improved disclosure can strengthen consumers' understanding of financial products and increase the odds of consumers getting the product that is best for them. But to the extent that increased disclosure requirements are simply a prelude to other measures that would reduce the availability of credit, we should be wary.

When weighing measures designed to protect borrowers, we should always keep in mind the inherent trade-off between preventing adverse effects for some and limiting the availability of credit to others. The evidence suggests that constraints on allowable interest rates are counterproductive and generally reduce consumer well-being. While some policies that carefully target truly abusive practices are warranted, the broader risk is of a regulatory overreaction that stifles much of the benefit of the technology-driven expansion in consumer credit.

One thing I think everybody can agree on is the usefulness of educating consumers about managing their financial affairs. Financial institutions depend critically on their customers' trust, and trust is built on their understanding the difference between a legitimate financial transaction and one that is too good to be true. Beyond that, an electorate that has a broad appreciation of the efficiency of credit markets will have an easier time sorting out when any particular policy proposal is truly in its interests.

The United States has arguably the most efficient retail credit markets in the world. We should avoid regulatory actions that would threaten a system that has served so many people so well.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND

Editor's Note: This article is based on a speech given on June 14, 2005, at the annual meeting of the North Carolina Bankers Association. To read the speech in its entirety, please visit our Web site: www.richmondfed.org

How Not to Stop Inflation

BY MILTON FRIEDMAN

EDITOR'S NOTE: *High and rising inflation can tempt policymakers to enact quick "fixes," such as wage and price controls. But as Milton Friedman argues in this speech, delivered in February 1966 to the Detroit chapter of the University of Chicago Alumni Association, such controls don't get at the fundamental source of inflation — excessive expansion of the money supply — and eventually make the problem worse. While in effect, the controls often result in shortages of goods, and when they are removed, the inflationary pressures that have been bottled up artificially tend to explode.*

Only five years after Friedman delivered this speech, President Richard Nixon enacted a program of wage and price controls. The system was supposed to last only 90 days but proved to be far less temporary, surviving in modified form for nearly three years. The results were predictable. The legislation was greeted with initial enthusiasm, but its problems were quickly apparent. By the mid-1970s, inflation had reached double digits. In his memoirs, Friedman wrote that Nixon's decision to impose the controls "did far more harm to the country than any of the later actions that led to his resignation."

Friedman, who won the Nobel Prize in economics in 1976, taught at the University of Chicago from 1946 to 1977 and is now a senior research fellow at the Hoover Institution. This speech, which has been edited for length, has never before been published. The full text is available at our Web site: www.richmondfed.org

Let me turn to my topic for tonight, "How not to stop inflation." As you know, the word "inflation" has a great many different meanings and people attribute different conceptions to it. What we mostly mean by it, and what I shall mean by it, is a rise in prices, in prices in general. In the past year or so, we have been having a tendency for a rather widespread rise in prices. That tendency seems to give every sign of intensifying and increasing, so we have a real problem of inflation.

If inflation does consist in a rise of prices — in the price of meat going up, of wages, and of all sorts of things — then it seems most natural to say that the way to stop it is to stop prices from rising. If you want to stop inflation, let's just pass a law saying that no price shall rise. That will stop it. The main theme of my talk tonight is to say that this tempting way to stop inflation is the way not to stop it. It will not in fact cure inflation, but even if it did, it would be a cure that is worse than the disease. This approach is like saying that if it's getting too hot in this room, the way to solve the problem is to break the thermometer.

Milton Friedman

PHOTOGRAPHY: THE UNIVERSITY OF CHICAGO NEWS OFFICE

This analogy is suggestive but does not go far enough. If you broke the thermometer, that would neither make it hotter nor do any other harm. It would just simply prevent a signal of the rising temperature from being seen. Prices partly do measure pressure, but they also affect the course of events. Perhaps a better analogy is the following: When it gets too hot in this room, close all the outlets from the furnace while letting the furnace run full blast until it bursts. That is more nearly a correct analogy to holding down particular wages and prices as a means of stopping inflation.

The question is, why is that a bad way to stop inflation? What harm does it do? In trying to suggest to you the answer to those questions, I want to talk about two main points. The first point is to discuss what the source of inflation is. If I were putting it as a topic for a Sunday sermon and could speak French, I would say, instead of "Cherchez la femme" — "Cherchez la monnaie." "Look for the money." Inflation is always and everywhere a monetary phenomenon. That is the first point I want to discuss.

The second point I want to discuss is that while we ordinarily talk about distinguishing between inflation and deflation, between rising prices and falling prices, there's another distinction that I think is even more important. That is the distinction between open inflation and suppressed inflation, between an inflation in which prices are permitted to rise and an inflation in which prices are held down. While inflation is bad, it is far better to have it open than it is to have it suppressed. Suppressed inflation is the case in which the cure is worse than the disease, like pouring coal into the furnace while locking all places where the steam can get out until the furnace blows up.

Let me turn to the first point. The common approach to inflation is to think that inflation, being a rise in prices, results from a rise in costs. With rare exceptions, every businessman and every ordinary person tends to think that the reason why prices go up is because they are pushed up because costs go up. This may take the form of a so-called cost-push spiral or wage-price spiral or other fancy terms, or it may take the simpler form of each man thinking he has to raise prices because his costs have gone up. It is perfectly natural that people should think this way because to each individual separately that is the way it looks. But the fact is that this has almost never been the source of inflation. It's the external manifestation of inflation, but not its source.

Indeed, this illustrates a much more general principle. What makes economics, in my opinion, a fascinating subject is that for almost any important proposition in economics, what's true for the individual is precisely the opposite of what's true for everybody together. That's why you have so many widespread economic fallacies. People generalize from their individual experience, and yet that is precisely the opposite of what holds for the community as a whole. Let me illustrate that in a very simple way, which is also related to the problem of inflation. Each one of us separately thinks he can decide how many of these green pieces of paper to keep in his pocket — subject, of course, to his total wealth. If any one of us wants to keep $20 more in his pocket, all he has to do is cash a check for $20 or sell a bond for $20 or use $20 of his income and keep it in cash instead of spending it or investing it in some other way. So each person separately thinks he can decide how much money to hold in his pocket, and each one is right. Yet for the community as a whole, the amount of currency to be held in pockets is a fixed number. There are only so many pieces of these green pieces of paper that have been printed. The way that you get more in your pocket is by persuading somebody else to hold less. This is a game of musical chairs in which the pieces of paper pass around. While each individual separately can decide how much to have, the community as a whole has nothing to say about how many pieces of paper there shall be to pass around. That's determined by the Federal Reserve Board or the Treasury or by some central agency. Whatever that amount is, it's shuffled around from person to person.

I think that's a very clear and straightforward example of how it is that the way it appears to the individual is the opposite from the way it appears to the community. The same thing is true with respect to inflation. The example I can give you which will bring this out most clearly is one which I have taken from a recent textbook in elementary economics. The authors, Armen Alchian and William Allen, have a wonderful little story in their book that will illustrate how it is that to each individual separately it looks as if what causes inflation is a rise in costs even though to everybody together what causes it is an increase in demand, a monetary phenomenon. Let us suppose, they say, that all of a sudden the housewives of America decided that they wanted to serve more meat on their tables, and so come Monday morning each one goes to the butcher and buys more meat. No butcher raises his price. He just sells out his meat and then he orders a larger amount of meat from the wholesaler. The wholesalers sell out and so they order the larger amount of meat from the packer. The packer finds his inventory going down and so he sends back instructions to the cattle buyers at the auctions to buy more animals. Well, of course, there aren't any more animals to be bought, so what happens is that the people trying to buy them bid up the price of the animals. They report to the packing houses, "We're sorry we've had to pay a higher price for the animals." The packing houses say, "Our costs have gone up so we must charge a higher price," so they charge a higher price to the wholesalers. The wholesalers say, "Our costs have gone up so we must charge a higher price," so they charge a higher price to the retailers. The butchers say to the housewives when next they come in, "We're very sorry to have to do this to you; it isn't our doing, but our costs have gone up so we have to charge you a higher price." Everybody along this chain, except way back at that auction where there is nobody who has any costs that he can look at in the same sense, is honestly charging higher prices because his costs have gone up. And yet, taken altogether, the increase in prices clearly reflects the increase in demand at the final stage.

That is the way it is in the economy at large. Every manufacturer says, "I have to charge higher prices because my wages have gone up," but the reason his wages have gone up is because there's been an increase in demand somewhere else which has led somebody else to try to bid his workers away from him, or he's been trying to bid workers away from somewhere else. The ultimate source of the increase in price has been an increase in monetary demand.

And now we ask the question, where does that increase in monetary demand come from? If there has been any substantial increase in monetary demand, it always has had the same basic source. Somebody has produced more money. The exact source of additional money has varied from time to time. In the period after 1896, after William Jennings Bryan was defeated in the campaign for free silver, prices rose in the United States from 1896 to 1913 by roughly 35 percent. That price rise came from an increase in the quantity of money which occurred because some smart people had figured out how to apply the cyanide process to extract gold from low-grade ore. The resulting great increase in the production of gold brought about an increase in the quantity of money, which in turn brought about inflation.

To go back to my main theme, on that occasion, inflation reflected an

increase in the quantity of money, but the particular reason why the quantity of money increased varies from time to time. On that occasion it increased because of gold. In World War I and World War II, in the United States the quantity of money increased very rapidly because government printed it to finance the war. Go back to the great price inflation in Europe in the 16th and 17th centuries and that came because of the discoveries of specie in the New World. There have been many reasons why the quantity of money has increased, but inflation has never occurred to the best of my knowledge except as a consequence of a more rapid increase in the quantity of money than in output.

In modern times, the quantity of money is under the control of governmental agencies. In the United States, it is determined by the Federal Reserve Board, the Treasury, the monetary authorities. And that means that if inflation is always a consequence of an increase in the quantity of money, the responsibility for inflation is always governmental. But, of course, as you know, no human being likes to take responsibility for things that are unpleasant or undesirable and so no governmental official likes to stand up in front of an audience and say, "Mea culpa, I'm responsible for inflation." What always happens is that the governmental officials stand up and say, if we have inflation it's because of those rapacious businessmen and those selfish union labor leaders. If those people would only stop demanding more and more, higher and higher wages and higher and higher prices, there would be no inflation. And the businessmen and the wage union leaders, surprisingly enough, tend to accept the indictment because of their misunderstanding of the elementary economic point I've been trying to present here.

The businessmen tend to say that the reason we have inflation is because those selfish unions push up wages, and the union leaders say the reason we have inflation is because those selfish businessmen raise prices and, therefore, we've got to get higher wages to have the same real income for our employees. So you have a situation in which the government, to blame somebody else, attributes inflation to a wage-cost spiral, and the businessmen and the labor union leaders accept the blame and say, yes, we are guilty. Yet in fact, as I have emphasized, the inflation arises from one and only one reason: an increase in a quantity of money.

That is my first point. The next point I want to discuss is the harm that is done by trying to stop inflation by holding down wages and prices. The president, members of the Council of Economic Advisers, and other prominent public officials make speeches about the terrible effects of inflation and about the urgent necessity for businessmen and labor union leaders to exercise a social responsibility in holding down wages and prices. Maybe the cause of inflation is an increasing quantity of money, but you may well ask, what harm would it do to try to stop it by holding down those wages and those prices?

In the first place, one of the major sources of harm it does is to lead people and the government to misconceive the nature of the problem. If the businessmen and the labor leaders accept the blame, the government goes on pouring coal into the furnace, increasing the quantity of money, and says that any resulting inflation is not its fault. So you tend to encourage a delay in adopting the remedy which alone can prove effective, namely, a slowing down in the rate of growth in the quantity of money. That's only a minor reason why it is harmful. A second reason is that it isn't going to stop inflation. It's like taking a great big balloon and thinking that by pressing one corner of it you are going to deflate the balloon. All you do is push the air into the other part of the balloon. In the same way, if you succeed in holding down some wages and some prices, all that does is push the inflationary pressure over somewhere else and make it stronger there. Suppose you succeed in keeping down, let us say, the price of steel which has attracted so much attention. That would simply mean that the purchasers of steel have more money left after buying steel than they would otherwise have had and they can now spend it on bidding something else up. If you keep down the wage rate of labor under these circumstances, it just means that the employers have more money to produce inflation somewhere else, so all you are doing is shoving the inflationary pressure over.

But you may say, that's only because we haven't gone far enough. If we really spread our net wide, if we held down every wage and every price, there's no place for the inflationary pressure to go. That's true, but let's look and see what the consequences would be. The consequences of that would be to destroy the price system as a means of organizing economic activity and you would have to substitute something else. What else would you substitute? If prices are not going to determine who buys how much, something else must do it.

Let me give you a historical example which perhaps makes my point most strikingly about the importance of the distinction between open and suppressed inflation. It has a very real parallel with strong implications for the United States although it's a much more extreme case. The best example, because it's almost a controlled experiment, is a comparison of experience in Germany after World War I and World War II. As you recall, after World War I in Germany there was an inflation that really was an inflation. It was a hyper-inflation. A student of mine some years back, Phillip Cagan, wrote a classic study of hyper-inflations, and he defined a hyper-inflation as beginning when prices rose more than 50 percent a month. In Germany during the height of hyper-inflation, there were periods when prices were doubling every day. In fact, it got to the point that employers were paying their workers salaries three times a day

— after breakfast, lunch, and dinner so they could go out and spend it before it lost value. That was really an inflation. Prices went up by amounts that you have to reckon by 10 to the 10th or 10 to the 20th, something like that.

The hyper-inflation did tremendous harm of a social kind. It destroyed the German middle classes, and it undoubtedly laid much of the sociological basis for the subsequent emergence of Hitler. But from a purely economic point of view, the striking thing about it is that, except for the last few months of the hyper-inflation, the level of economic activity remained high. Inflation was open, prices were free to rise, there were no price controls of any kind, and, consequently, people were free to continue to do business. There were certain kinds of inefficiencies produced but you never had any major decline in the aggregate level of production. Indeed, as you may recall, 1920 to 1921 saw a worldwide depression. In the United States prices fell by nearly 50 percent from 1920 to 1921. Germany was almost the only country in the world to escape that depression. While the rest of the world was having a decline in output, Germany was booming. There was an artificial kind of a boom that had great social costs, but from the purely technical point of view, the inflation did not prevent the economy from operating.

After World War II, Germany was again faced with an inflationary problem, but it was an inflationary problem of enormously smaller scope. Prices rose about fourfold. Now that seems like a big inflation and it is. For prices to go up to 400 percent of their initial value is a substantial price rise. But it is negligible by comparison to what happened after World War I. Yet that rise was not permitted to happen openly after World War II. There was widespread price control. Under those circumstances, price control can almost never be enforced. From the time of the Roman Empire to the present, you cannot in general enforce price controls when there is that big a discrepancy between the market price and the controlled price.

Friedman (right) with President Nixon and George Shultz in the Oval Office in 1971, the year the Nixon administration imposed wage and price controls.

PHOTOGRAPHY: COURTESY OF MILTON FRIEDMAN

But Germany from 1945 to 1948 was an exception because there was an American, a French, and a British occupation army there, and they were enforcing the price controls. So you had about as well-enforced price controls as you could imagine. The result was that, because this inflation was suppressed, the prices were not allowed to find their own level, and output in Germany was cut in half. Walter Eucken, a German economist, wrote a wonderful article on this experience in which he tells the story of workers in a factory making aluminum pots and pans who would work in that factory for three days a week. They would receive their pay in the form of some of the pots and pans they had helped to produce. They would spend the rest of the week scouring the countryside trying to find a farmer who was willing to trade them some potatoes for those pots and pans.

The problem is, if you don't let prices rise, you destroy the system which organizes the economy, the price system which coordinates the activities of different people. You force people into the inefficiency of barter, or a man producing pots and pans trying to find a man who has potatoes, instead of selling the pots and pans for money and using the money to buy the potatoes. And so Germany with a very much smaller inflationary pressure had an enormously greater reduction in its economic output. Indeed, the action taken in response to this episode is the reason Ludwig Erhard is chancellor of Germany today.

One Sunday in 1948, Erhard, who was economics minister then, released an announcement that all price controls were abandoned. He did it on Sunday because that was the day on which the Allied offices of military occupation were closed and so they couldn't contradict his order. Immediately, there was a very sizable rise in recorded prices, but immediately also the price system started operating again. That was the source of the German economic miracle, as it came to be called, which produced a tremendous increase in the total output of Germany over the next year or two. There was no mystery about it. It had nothing to do with the capacity of the German people for hard work or with any special wisdom of the American occupation authorities or with any assistance from us to them.

It solely was a case of substituting an efficient money system for an inefficient barter system.

The money system is so important that if you prevent it from operating efficiently something else will come along. In the period from 1945 to 1948 in Germany, as you may recall, substitute monies developed. Germans started to use cigarettes as a form of money: cigarettes for small transactions and Cognac for big ones. That was when they really started talking about the importance of having adequate liquidity. And you may remember that there were stories in American newspapers of this time saying something like, "Look at these crazy Germans. They just got beaten in the war and they are poor and devastated. Yet they are willing to pay $1.50 for a package of cigarettes. How silly can they be?" The answer, of course, is that they were no more silly than you are when you're willing to pay $10 for a piece of paper (a $10 bill) that's only worth a penny as paper. You don't pay $10 for this piece of paper in order to burn it or to write notes on it. Neither were the Germans paying $1.50 or $2 for a package of cigarettes in order to smoke them. That was money because prices in terms of cigarettes were not controlled, and it developed as a very inefficient substitute money.

The repressed inflation in Germany was far more destructive of economic output and productivity than the open inflation after World War I. And this is true more generally. Let me come back to the United States to see some parallels in very small ways. Not long ago, there was pressure on American copper producers not to raise the price of copper. The next step, of course, is that, since copper is selling for a higher price abroad than it is at home, everybody wants to export it and nobody wants to import it. People want to buy it from copper producers at home. The next step is to impose export quotas on copper. Now if you want to export copper, you are prohibited from doing so unless you can get a permit from the Department of Commerce. This is inevitable. If you are going to fix the price of copper, then you will have to decide who shall buy copper at that lower price, and so it goes all down the line.

> Wage and price controls destroy the system which organizes the economy.

We have so far in the United States had the most extensive experience with repressed inflation in an area where it is most destructive, namely, foreign exchange. We have been pegging for some years now the price of the pound sterling in terms of the dollar, the price of francs in terms of the dollar, the price of gold in terms of the dollar, and so on. And we have had the usual consequences from price fixing. You know, economists may not know very much, but there's one thing we know. We know how to produce either surpluses or shortages. You just tell us what you want. If you want to have a surplus, we'll tell you to set the price too high. Have a high price on wheat and you'll be sure you'll have wheat running out of your bins. If you want a shortage, we'll tell you to set a low price. Put rent control on rental quarters in New York, and you'll be sure you will have a shortage of dwelling units to rent at that price.

We've been doing pretty well in the case of silver with first creating a surplus and then creating a shortage. We've had it both ways in that case. Incidentally, the story of silver is fascinating. In the 1930s, we had a silver purchase program that, as it happened, was one of the main reasons why China is communist today. I won't go into that one right now, except to note that under the silver purchase program we raised the price of silver in one year from 25 cents an ounce to 75 cents an ounce and subsequently to 90 cents. Of course, this brought a tremendous inflow of silver into the U.S. Treasury just as our price fixing in wheat did. We kept the price of silver at the same level and in the meantime prices in general more than doubled. Hence, a very high price became a very low price and now, in order to prevent the price of silver from rising above $1.30, we've had to sell silver out of these stocks. We've had a shortage and, as you know, we've substituted Federal Reserve notes for silver certificates, and sandwich coins for solid coins. So we know how to produce shortages or surpluses.

That's what has been happening in the foreign exchange market. We've been pegging the price of the dollar. The result has been a whole series of direct interferences with individuals and with trade. You know as individuals some of the minor irritants, things like the reduction of the duty-free allowance tourists can bring in. Much more important has been the interest-equalization tax which has established a differential exchange rate, a devalued exchange rate for capital transactions. Also, there are oil import quotas, copper export quotas, and I can't begin to name the host of specific quantitative controls that have been promoted by the attempt to peg exchange rates.

I mentioned foreign exchange pegging because that is a particularly important type. The example that comes to mind in this case as a cautionary tale of where it can lead you to is India. India is a country which has been having inflation over the past decade or so, and it has been repressing it the way in which we have been trying to repress it here. The key in India is the exchange rate of the rupee. The official price of the rupee is 21 cents, 4.7 rupees to the dollar. If the rupee was worth 21 cents five or 10 years ago it is certainly not worth it now because prices have gone up 30 or 40 or 50 percent. I'm not sure of the latest figures. But India has tried to maintain that exchange rate. The result is, of course, that everybody wants to

import and nobody wants to export. So you then have quotas and exchange permits on imports and subsidies on exports. You have to ration imports of steel, copper, and so on.

The next stage is it becomes of great economic value to have an import permit. Indeed, if you ask what has been the major source of new fortunes in the last 20 years in the world, including the United States, there is no doubt it has been getting the ear of governmental officials to get special permits, whether it be to have a single television station or to have a permit to import copper. In India this is very widespread. There's enormous corruption and bribery involved in the exchange permit system. Indeed, the major obstacle to having a devaluation of the rupee exchange rate or allowing the rupee to go free is that there are now so many people who have vested interests in the exchange rate system because they have the import licenses.

Exactly the same thing is true in this country. The permit to export copper is a valuable thing now. I mentioned the TV and radio stations, and that's a special example of the same kind of thing. Here you have something that's worth several millions of dollars if you get it, and if you get it, you get it for nothing. Then people are surprised why there should always be charges of corruption and bribery in connection with television and radio licenses.

To come back to my main theme, the effect of trying to hold down prices by suppressing individual prices and wages is to eliminate the central governor of the economic system, the central method by which we organize our economic activity. If you insist on doing that, you are going to have to substitute something else. You are going to have to engage in rationing and indirect controls. You are going to have to decide who shall buy from whom and how much. The effect, therefore, of trying to stop inflation by holding down individual prices and individual wages is to introduce enormous inefficiencies and to expand very greatly the scope and extent of direct controls.

This, in turn, has a further effect which is the final consequence I want to mention of trying to stop inflation by holding down prices and wages. The effect is of a political character. We have had a number of episodes in the past five or six years in which there's been an attempt to hold down wages and prices. We had the Kennedy confrontation with the steel industry in 1962. We had the more recent episode with aluminum. The interesting thing to me is the drastic change that occurred between the first and the second episode in the willingness of businesspeople who were potentially affected by it to speak out freely and express their sentiments about it. And I don't blame them.

There is no legal authority whatsoever whereby the president or any other official has the power to require the aluminum company or the steel company to hold down its prices or a union to hold down its wage rates. There is no official authority, but there is lots of power lying around Washington. There are lots of extra-legal pressures that can be brought to bear. After all, there's hardly a man in the country who cannot now be subjected to great inconvenience by having a tax official suddenly decide that his return needs extra careful scrutiny — and which return doesn't?

The threat of antitrust action is not something which any businessman is going to take lightly. There is a wide range of governmental contracts that are available. The attempt to hold down particular wages and prices produces a resort to extra-legal power, which, in its turn, tends to spread and to lead to a suppression of individual and personal and political freedom and to a great lessening of the willingness of people to dissent. These are some of the consequences of the attempt to stop inflation by holding down particular prices and wages.

I think they are extremely serious both from the point of view of economic efficiency and from the point of view of the preservation of political freedom. If we are going to have inflationary pressure we should have it open — let prices rise, let it go. Better yet, of course, would be to remove the source of the inflationary pressure by slowing the rate of expansion of money.

After the 1960 recession, itself largely produced by a sharp retardation in monetary growth, indeed an absolute decline, the Federal Reserve System did the right thing by increasing the rate of growth. They have also done the right thing by maintaining a fairly high rate of monetary growth. This is the main source of our long continued expansion. Unfortunately, however, they overdid a good thing and expanded the quantity of money at too high a rate. This has built into our society some pressures driving toward higher prices. We cannot eliminate this pressure and stop the inflation without paying a price. The danger is that if we try to do so, as we sooner or later will have to, by curtailing the growth of the quantity of money, that we will go too far, that we will overdo the reaction. Even if we don't overdo the reaction, there is no way of bringing inflation to a halt suddenly. There is already built into the economy forces for making price increases.

If you were to take the correct and proper measures, which is to slow down gradually the rate of growth of the quantity of money, there will for a time be a continuation of inflation at the same time that we experience some measure of recession and unemployment. That is part of the price we are going to pay for having in the past three or four years stepped on the accelerator too hard. But that will be far better and a far lower price than to continue along our present lines of trying to conceal the inflationary pressure by appealing to the social responsibility of business leaders and labor leaders, reinforced by an appeal to unnamed and unspecified exercise of governmental power.

Thank you. **RF**

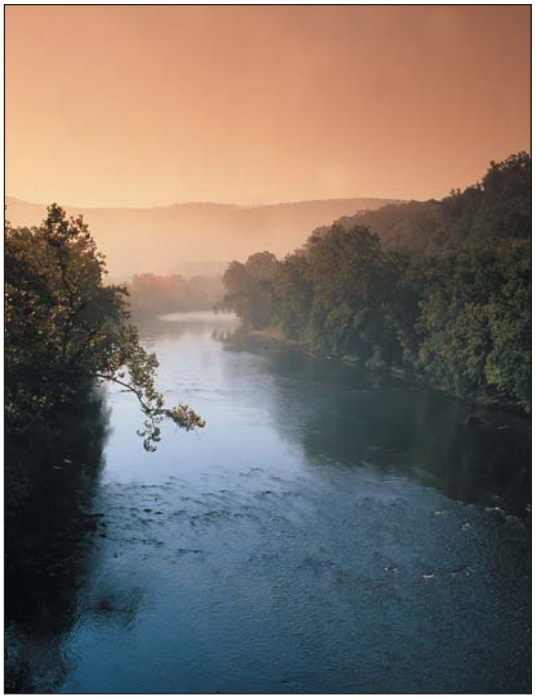
SOLD!

James River Islands Auctioned

On Feb. 22, close to 300 people packed a Richmond auction house to bid on some very unusual property: 39 islands scattered across a short stretch of the James River.

Located in Goochland County, several miles up the river from Richmond, these islands range in size from 5 acres to one-hundredth of an acre. Potential buyers were informed that the acreage depends on the water level and that some of the islands are below water part of the year.

Bidders were not thwarted by this news — or by the fact that ownership of five of the islands was contested at the time of the auction. According to Tim Dudley, vice president of real estate for Motley's Real Estate and Auction Group, all 39 islands were bid on, and the islands with contested ownership sold for approximately $6,000 per island.



A love of the outdoors and a desire to have their own place to enjoy it drew about 300 people to the February 2005 auction of 39 islands located on the Goochland County stretch of the James River.

Why would people be willing to buy up the islands, despite the iffy conditions? For most buyers, it was a love of the great outdoors, to have their own place to camp, fish, hunt, and enjoy watching wildlife.

"Many islands are now being claimed because of the land value and because land that might have been unimportant years ago has taken on a different perspective. They're great as a recreational opportunity," says George Sydnor, the Richmond businessman who sold the islands at the February auction.

According to a recent survey from the U.S. Fish & Wildlife Service, wildlife-related recreation is a $108 billion industry nationwide, 12 percent of which is leasing or buying property for such recreation.

Furthermore, an increase in outdoor recreational hobbies — combined with higher disposable incomes and lower interest rates — has played a role in creating a niche market for recreational land.

All of the islands sold on the day of the auction, but some buyers decided not to go through with the deal. For example, one man who took his surveyor out to the river, could not find "his" island and backed out. — JENNIFER SPARGER

MOVING ON

GM Plant Closure Frees Up Prime Parcel

At its peak, General Motors Corp.'s van assembly plant in southeast Baltimore employed 7,000 workers. At the beginning of 2005 that number was down to 1,100, and it dropped to zero on May 13 when the automaker closed the plant for good.

But the blow of losing yet more Fifth District manufacturing jobs is somewhat blunted in this case. Economic developers view the closure as a rare opportunity to create a new industrial park in one of the state's prime pieces of real estate.

News of the planned closure last fall sparked a virtual cottage industry of proposals for what to do with the site. (The announcement came well before June's report that GM planned to shed 25,000 workers from its payrolls over the next few years.) No wonder. It sits on 182 acres nearby the Port of Baltimore.

"There's a lot of demand for how we redevelop this land," says Aris Melissaratos, Maryland's economic development secretary. "The strategy for developing this land is key to the future growth of the port."

A GM spokeswoman says the company continues to explore options. It can take more than a year to decommission plants like the one in Baltimore, which most recently made GMC Safari and Chevy Astro minivans.

The plant closure came as little surprise to state officials. The good news, Melissaratos says, is that 70 percent of the GM workers were retirement-eligible.

Melissaratos has backed Gov. Robert Ehrlich's request that GM donate the property to the state and further asked that the company open a research and development facility on the site.

The secretary thinks up to 5,000 jobs can be created on the site which would be called the Baltimore Global Trade and Technology Center and include GM's R&D unit, mid-rise office buildings, and port-oriented manufacturing and distribution operations. Melissaratos thinks groundbreaking for the new buildings should happen simultaneously with demolition of the van plant.

PHOTOGRAPHY: DWIGHT DYKE, VIRGINIA DEPARTMENT OF GAME AND INLAND FISHERIES

Despite the optimism, taking full advantage of the abandoned site is a steep challenge. GM workers were paid an average of $27 an hour, and even in a market with low unemployment, matching those wages may be a stretch. Still, Melissaratos is undeterred. He sees the redevelopment of the site as part of a larger "transformation of Maryland's old manufacturing economy to a new knowledge economy." — Doug Campbell

COVERING THE UNINSURED

Maryland Governor Vetoes "Anti-Business" Health Benefit Mandate

Concerned about the growing number of working Americans lacking health insurance or dependent on Medicaid, Maryland lawmakers in April mandated that large employers spend a minimum amount of money on health benefits. A month later, the law was vetoed by Gov. Robert Ehrlich, Jr. as being anti-business. Ehrlich also vetoed a bill that would have increased the state's minimum wage by a dollar.

The Fair Share Health Care Fund Act would have required companies with more than 10,000 employees to devote at least 8 percent of their payroll to health insurance, excluding wages paid in excess of the state median income. Alternatively, large firms would have to pay the difference between their health insurance costs and 8 percent of total wages into the state Medicaid fund.

Four companies in Maryland have that many workers: Giant Foods, Johns Hopkins University, Northrop Grumman, and Wal-Mart. Only Wal-Mart would have had to increase its spending on benefits, which is why the law was widely regarded as targeting the mega-retailer.

The law was aimed at low-skilled workers whose employers often don't provide comprehensive benefits packages and whose relatively low wages make it difficult for them to purchase insurance on their own. "Somebody still has to empty the trash, park the cars in the garage, and landscape yards," says Tom Hucker, executive director of Progressive Maryland, which lobbied for the vetoed legislation.

Still, Maryland's mandate for employer health benefits wouldn't have addressed why some salaries aren't keeping up with health costs. Also, it wouldn't have helped many thousands of other workers who aren't employed by large companies. According to a December 2003 report by the Kaiser Commission on Medicaid and the Uninsured, 49 percent of uninsured workers nationwide are either self-employed or at firms with less than 25 people.

A proposal to cover a broader range of companies failed to pass the state's General Assembly last year. "Lawmakers are very sensitive to small-business owners who are trying to create jobs," explains Hucker.

Economist Aaron Yelowitz at the University of Kentucky says it's hard to know how much Maryland's health benefit mandates would have affected businesses, but he thinks that they could have had unintended adverse effects. "If you make Wal-Mart pay more for health insurance, they might simply lower other forms of compensation," notes Yelowitz. Or companies could reduce the hours of part-timers to make them ineligible for benefits. In Hawaii, the only state that mandates health coverage of employees, the percentage of people working 20 hours a week or less is higher than the national average due to businesses trying to skirt the mandate. — Charles Gerena

BACK BY POPULAR DEMAND

Fifth District Utilities Seeking Permits for New Nuclear Capacity

It's been almost 30 years since an American power company ordered a new nuclear power plant. Now, three groups of reactor makers and utilities, including major players from the Fifth District, are seeking to break that drought.

In the past, power companies had to apply for separate licenses to build and run a plant, each of which required extensive regulatory and public scrutiny. That's why Congress took several steps to streamline the licensing process in 1992, one of which was to create a single construction and operation license (COL).

Despite this change, power companies didn't rush out to apply for a COL. Instead, they chose to upgrade their existing nuclear plants.

The reluctance to build nuclear plants has softened in the last few years. Fossil-fuel prices have risen, electricity demand has increased, and power companies have faced pressure to reduce their emissions. These factors have put nuclear power back on the table along with other alternatives.

"We have to look at our customer needs and the most economical way to meet them," says Rita Sipe, spokeswoman at Charlotte-based Duke Energy. Duke belongs to NuStart Energy Development, one of the three consortiums that applied for a COL in response to the U.S. Department of Energy's November 2003 solicitation. To provide an incentive for companies to test the licensing process, the agency offered to cover up to half the cost of the process, estimated at $400 million.

Filing a joint application helps spread out the financial burden and risks among the eight consortium members that are power companies, including Duke, Baltimore-based Constellation Energy, Raleigh-based Progress Energy, and EDF International North America in Washington, D.C. Each company contributes $1 million to the consortium and will have an equal share in any new plant that is built using the COL.

Marilyn Kray, president of NuStart, says the group is evaluating potential plant sites and working with consortium members General Electric and Westinghouse to have their reactor designs certified by the National Regulatory Commission. If all goes well, NuStart's COL application could be ready for submission within the next three years and construction could begin on a plant by 2010. — Charles Gerena

JargonAlert

Monopoly

BY AARON STEELMAN

Economic terms don't often find their way into everyday parlance. There are a few exceptions, though. Consider the term "monopoly." In a debate, for instance, you might hear one person tell the other that "no one has a monopoly on the truth." What the person means is that there isn't just one side to an issue — there are two or maybe even more.

In economics, the term "monopoly" is used in a similar way. When there is only one seller of a good or service, that company is dubbed a monopoly.

Economists object to monopolies because they can lower social welfare. The reason is that the monopolist can raise the price of its good or service above the competitive level, to a point where consumers demand less of the product than they would otherwise.

Consider the case of a monopolist widget maker. He can produce widgets at a constant cost of $2 per unit. If he charges $3 for the good, he can sell 600 units, while if he charges $4, he can sell only 400. You might initially think that he would choose to charge $3 so that he could sell more widgets. But charging $4 is actually more profitable. Under that scenario, he makes a profit of $800 (400 x $2). At $3 per widget, his profit is just $600 (600 x $1). From the point of view of the widget maker, producing fewer widgets is the rational thing to do. But society is made worse off. If the market were competitive, more widgets would be produced and consumed.

Similar problems can arise in the case of an "oligopoly." This is when a market is dominated by a small number of firms. If those firms decide to coordinate their actions and raise prices above a competitive rate — thus forming a "cartel" — the oligopolists in effect act like monopolists.

How common are monopolies and oligopolies in the real world? And do they typically lower social welfare in the way described above?

Some industries *have* been dominated by only a few firms. Take the auto industry, for example. From the 1950s through the mid-1970s, the "Big Three" automakers — General Motors, Ford, and Chrysler — dominated the U.S. auto market. During that period, they regularly produced about 90 percent of all vehicles purchased domestically. Now, however, that figure is down to about 58 percent.

Many Americans were unhappy with the choices offered by Detroit, and turned instead to cars from foreign automakers. Ultimately, competition from abroad forced the American companies to improve their products — to the benefit of everyone. This is the case of an oligopoly collapsing, as consumer sentiment shifted and barriers to entry — such as import restrictions — became less burdensome.

But what if an oligopoly doesn't collapse? How dangerous is it? The late George Stigler, whose work on industrial organization won him the Nobel Prize in economics in 1982, long favored antitrust laws aimed to break up oligopolies, but over time lost his "enthusiasm for antitrust policy and much of our fear of oligopolies."

Antitrust laws, Stigler believed, were actually being used by some companies to prevent competition rather than to increase it. And in other cases, they were a barrier to potentially useful mergers.

In addition, empirical analysis led Stigler to believe that oligopolies often were unable to earn returns much above what we would expect in a competitive market. "The relationship between profitability and concentration is almost invariably loose: less than 25 percent of the variation in profit rates across industries can be attributed to concentration," Stigler wrote.

Why might this be the case? There are several possibilities. One is that cartels are inherently unstable. A small number of firms may collude to raise prices. But there is always an incentive for one of those firms to defect, lower its price, and gain the lion's share of the market for itself. Another reason is that the mere threat of a startup company entering the market and taking business away from existing companies can exert discipline on monopolists and oligopolists, making them behave as if competition were brisk.

Some monopolists and oligopolists, however, enjoy government protections that shield them from such competition. The taxi industry is one example. In many cities, the number of cabs in operation is tightly controlled by local officials. The U.S. Postal Service is another. Companies like FedEx can compete on the shipment of packages, but with a few exceptions cannot deliver letters.

In theory, it's easy to see why monopolies and oligopolies could be socially undesirable. In practice, though, the evidence is not so clear, and the actions used to prevent industries from becoming concentrated sometimes can produce effects worse than the problem itself. **RF**

ILLUSTRATION: TIMOTHY COOK

Why Regulations Fail — Yet Persist

BY AARON STEELMAN

Regulations often do not achieve their intended effects. In fact, sometimes they produce results counter to their goals. Why?

In a lecture delivered at the AEI-Brookings Joint Center for Regulatory Studies in September 2004 and later reprinted in monograph form, economist Sam Peltzman of the University of Chicago argues that regulations fail when they create incentives for "offsetting behavior" — actions that negate some or all of the regulations' desired effects.

Peltzman offers three examples of offsetting behavior undermining a regulation's effectiveness. The first is auto safety, an area in which he has written some influential — and controversial — papers. The National Traffic and Motor Vehicle Safety Act of 1966 mandated the installation of seatbelts, collapsible steering columns, and pop-out windshields. Such devices should make the roads safer, right? Yes, if their presence did not alter the behavior of drivers. But Peltzman argued that the safety devices effectively lowered the cost of driving dangerously, since drivers would be better protected in the case of an accident. His prediction has been largely supported by subsequent empirical work. "The actual effect of the safety regulation on the death rate is substantially less than it would be if real people behaved like crash dummies," he writes.

"Regulation and the Natural Progress of Opulence" by Sam Peltzman. AEI-Brookings Joint Center for Regulatory Studies, September 2004.

A second example involves the Americans with Disabilities Act (ADA). The ADA, he argues, has actually reduced employment opportunities for people with disabilities. The logic is as follows. Prior to the ADA, employers could hire people with disabilities and observe whether their value to the company exceeded their wages plus any special costs of accommodating them in the workplace. If it did, they would be retained. If not, they would be let go. But now employers are wary of taking a chance on hiring someone with a disability because companies who terminate a disabled worker are potentially subject to large penalties for employment discrimination. Of course, the companies may also be subject to penalties for not hiring the disabled worker in the first place, but Peltzman argues that such discrimination cases are harder to prove.

Peltzman's third example has a Fifth District connection. The Endangered Species Act of 1973 is designed to protect animals on verge of extinction and their habitats. One such animal is the red-cockaded woodpecker, native to the commercial forests of North Carolina. Owners of forests where the red-cockaded woodpecker lives are forbidden to remove trees in those forests. But, of course, woodpeckers fly around and establish nests in nearby forests. If you own a nearby forest, "your incentive is very clear — cut down all those trees now! If you wait and your land becomes habitat for this species, your lumber will be lost." This is not good for the birds. Nor is it good for the owner of the forest, who might have preferred to allow the trees to grow larger before removing them.

So if such regulations fail to meet their objectives, why do they persist? In some cases, regulations benefit a relatively small group of people who lobby for their survival. Consider the ADA. It may harm people with disabilities who are looking for jobs, while helping disabled people who are already employed. The latter obtain "better working conditions, no lower pay, and an option on a future antidiscrimination complaint to the Equal Employment Opportunity Commission," Peltzman writes. "The beneficiaries know who they are. The victims ... often do not."

This explanation is consistent with many other case studies of the political economy of regulation. But Peltzman argues that a more powerful force is at work. The enormous progress characteristic of a society with a well-functioning economy can hide the failures of regulation. "As long as the thing being regulated is seen to be working tolerably well — and that will often be the case in a growing economy — then the regulation is safe politically," writes Peltzman.

If correct, does Peltzman's argument render economic analysis irrelevant to policy discussions? After all, if the public sees only what is before them and not how life might be different, and perhaps even better, in the absence of regulation — the type of thing that economic analysis tries to do — they are unlikely to push for change.

Peltzman is cautiously optimistic. "It may be true that economic analysis cannot all by itself change a well-entrenched mode of regulation. But economic analysis does often, I believe, play an important catalytic role when regulatory issues become politically salient." In other words, when a regulation's failures become manifestly obvious — as was the case with the regulation of the transportation industry in the 1970s — economic analysis can bolster the case for revising or repealing that regulation. **RF**

Policy Update

Freer Trade in Textiles Changes Import Sources

BY BETTY JOYCE NASH

The end of textile quotas in the United States is rearranging textile production worldwide. The set of quotas known as the Multifiber Arrangement (MFA), aimed to keep domestic manufacturers from being overrun with competition, expired at the end of 2004. The total level of imports hasn't risen dramatically as a result, but the sources of the goods have been sharply affected.

Total U.S. imports of textile and apparel rose 6 percent in March compared to the same month in 2004. But imports from China, India, and Bangladesh rose by about 43, 31, and 45 percent, respectively. Meanwhile, imports from Mexico, Hong Kong, South Korea, and Taiwan fell sharply.

March is the first month from which meaningful data can be drawn, since it's the first truly quota-free month, according to Donald Brasher of Global Trade Information Services, Inc., a trade statistics company. He explains that the January and February trade data included goods shipped in late 2004, under the quota regime.

The U.S. Department of Commerce responded in May to heavy Chinese imports in some categories by placing "safeguards" on certain textiles from China, including cotton pants, shirts, and yarn.

It won't help domestic producers, Brasher says. "It is a total nonissue; it'll only come in from other countries," he predicts.

Textile/Apparel Tally*

Overall	**6%**
China	43%
India	31%
Bangladesh	45%
Mexico	-11%
Hong Kong	-30%
S. Korea	-20%
Taiwan	-18%

*Textile and Apparel Imports, March 2005 over March 2004

SOURCE: Global Trade Information Services, Inc.

The fear of Chinese imports flooding the U.S. market is only the latest in a long line of import threats. The United States restricted Japanese textile imports after that country became the world's largest textile exporter in the 1930s. By 1960, the United States had limited imports from Hong Kong, Pakistan, and India, too. Twelve years later, the United States had agreements with 30 countries, and by 1994, 40 countries were affected, according to the Economic Research Service of the U.S. Department of Agriculture. As imports were restrained from one country, production moved elsewhere.

Pietra Rivoli, an economist at Georgetown University and author of *Travels of a T-Shirt in the Global Economy*, argues that the MFA hastened globalization.

"Each time a hole in the import dike was plugged by quotas — on cotton socks from China, say, or silk ties from Thailand — the effect was not to preserve U.S. jobs, but instead to increase the force of imports gushing in from other countries and categories," she wrote recently in *YaleGlobal*, an online magazine.

Textile industries in the United States have difficulty competing with countries where production costs are cheaper. Labor-intensive production moves from country to country. The garment industry gives poor countries a leg up in the quest for industrialization.

"What does a textile industry do for a country?" asks Brasher, who has helped establish textile manufacturing in Bangladesh and other developing countries. A lot, he says. Just consider the case of Manchester, England, a city that grew dramatically in the 18th and 19th centuries as textile production boomed there, and is now considered one of the birthplaces of the Industrial Revolution.

Many observers fear that the textile industries in poor countries can't compete with China.

Fifth District textile firms are continuing to shut plants. Springs Industries, based in Fort Mill, S.C., has closed six since last year. WestPoint Stevens' most recent cuts include 1,905 jobs in North Carolina, and VF Corp. is closing its Wilson, N.C., jeans plant in 2006, putting 445 people out of work. National Textiles shut its Greenwood County, S.C., plant in June, costing 390 jobs.

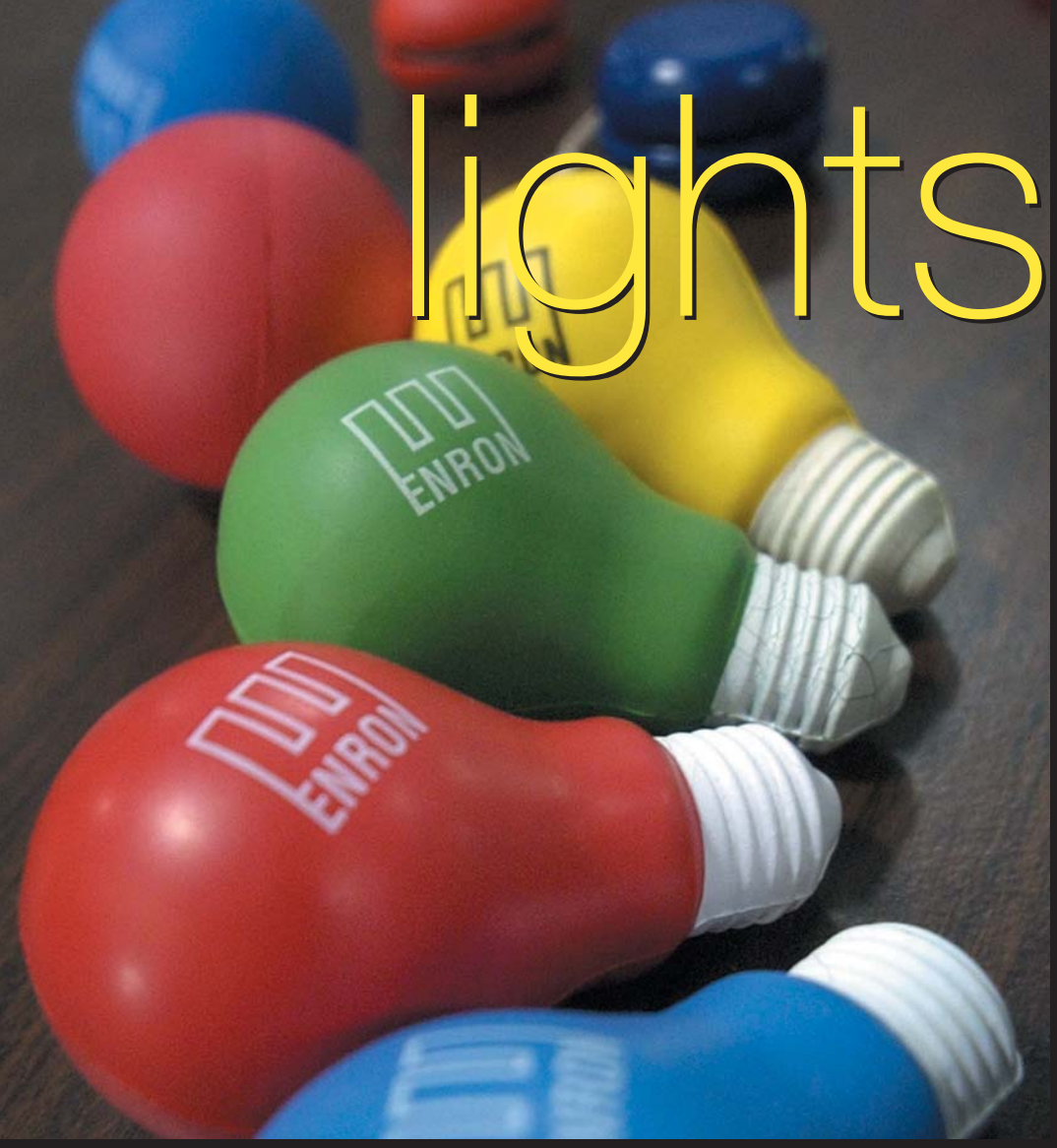
Some of the closings can be attributed to disappearing protections. But the quotas didn't save the domestic textile industry, notes Edward Gresser, director of the Progressive Policy Institute's Project on Trade and Global Markets.

"If you look at the quota system — it became effective in 1974 — at that time there were about 2.5 million people working in textile and apparel" in the United States, says Gresser. "Now there are half a million. It really wasn't very good at keeping jobs anyway."

By shedding workers, textile firms in the Fifth District hope to stay competitive. "It has been more intense than even our worst calculations," says Ted Matthews, Springs Industries' spokesman. He attributes the most recent six plant closings directly to the quota-free environment. Springs Industries is a 118-year-old, privately held textile company.

With vast new capacity worldwide, customers demand rock-bottom prices. World prices for the firm's key product lines, sheets and towels, have plummeted. "Admittedly, [Springs] will have a much smaller number of facilities than we have had historically," Matthews says.

While quotas may have delayed some job losses they've increased prices by 5 percent to 10 percent, according to the Economic Research Service. **RF**



lightsout

Three years after the enactment of the Sarbanes-Oxley Act, questions are mounting about unintended consequences for hundreds of U.S. firms

BY DOUG CAMPBELL

Squeezable lightbulbs with the Enron logo were just one of a warehouse full of items auctioned off after the company's demise in 2001.

On March 17, shares in discount men's clothier S&K Famous Brands fell 8.6 percent. Executives at the Richmond-based firm were hardly surprised. In fact, Chief Financial Officer Robert Knowles had thought the dive might be steeper.

The day before, S&K had announced that it was terminating its registration under the Securities and Exchange Act of 1934. In market slang, S&K was "going dark." No longer would the company file quarterly and annual reports on its financial condition, and so no longer was the ticker symbol SKFB welcome on the Nasdaq National Market. S&K shares would instead trade on the Pink Sheets, land of the penny stocks, where Securities and Exchange Commission noncompliance is no barrier to membership. S&K officers said they wouldn't have done it if not for the Sarbanes-Oxley Act of 2002. A press release summed it up this way: "The increasing financial cost and commitment of management's time to regulatory compliance have become a burden that will only increase over time."

Knowles estimates his firm can save $300,000 a year by sidestepping just a single component of Sarbanes-Oxley, Section 404, which requires a detailed, independent review of a company's internal financial reporting controls — plus a signed declaration from top executives and auditors that those controls actually work. For S&K, such a review is a budget-buster.

Among other things, compliance would mean documenting how a large sample of S&K's 240 stores in 27 states report each and every transaction — that is, everything from the sale of a $20 necktie to the return of a $500 suit, how they are keyed in, and how they are stored in the warehouse. These are already well-documented procedures at S&K, but reporting under the new rules would bring about, for one thing, the hiring of a second auditor to conduct its own review of S&K's internal operations. Knowles frowns in explaining it all. "It's not a necessary procedure for us," he says. "The shareholder isn't going to get anything more out of Section 404 — other than the fact that we spent $300,000."

S&K's management is far from alone in this sentiment. Corporate America has a new scourge: Sarbanes-Oxley. High-profile critics include the U.S. Chamber of Commerce and the *Wall Street Journal* editorial page.

PHOTOGRAPHY: AP/WIDE WORLD PHOTOS

Citing the new rules, a growing number of firms since 2002 have either stopped making filings with the SEC or gone private. (Unlike "dark" firms, companies that go private stop trading to public investors and usually, but not always, repurchase all of their outstanding stock.) This was not exactly what lawmakers had in mind as a remedy to corporate scandals like Enron and WorldCom.

A new crop of studies lends some support to the claim that Sarbanes-Oxley may be having the unintended effect of driving firms, especially small ones, from the SEC's watch. These findings are in keeping with standard economic theory that excessive regulation is bad for business — and the wider economy as well.

A broad spectrum of analysts and observers agree that portions of Sarbanes-Oxley — chiefly, the notorious Section 404 of the act — provide few direct benefits to investors and even fewer to the companies trying to implement them. Even after Sarbanes-Oxley, internal controls were responsible for detecting fewer financial frauds than those detected by tips, internal audits, and "by accident," according to a 2004 survey by the Association of Certified Fraud Examiners. Meanwhile, critics say Sarbanes-Oxley amounts to a gift to the accounting industry, requiring as it does extra auditors and accountants.

But a closer look at the studies and the firms going private or dark is revealing. First of all, this involves only a tiny fraction of companies that trade in the U.S. public markets. Despite all the chest-pounding over rising compliance costs, a large majority of the approximately 17,000 publicly traded U.S. firms remain under the auspices of the SEC. What's more, for many, getting out of the SEC's view might have been a prudent move even without Sarbanes-Oxley. These are generally small firms that were already on the public-private margin — and that may even go for S&K Famous Brands.

Conflicting evidence like this makes it difficult to assess the effects of Sarbanes-Oxley, especially on small firms. It is entirely plausible that many large corporate frauds have been prevented because of Sarbanes-Oxley. Such deterrence would have a significant and positive impact on the economy. The problem is that it is very hard to measure this possibility. Three years, it seems, has not been enough time to figure out whether Sarbanes-Oxley went too far.

In the Wake of the Crash

Sarbanes-Oxley took effect under the banner "Public Accounting Reform and Investor Protection Act" when President Bush signed it into law on July 30, 2002. It was universally regarded as the most substantial overhaul of U.S. business regulations since the enactment of the Securities Exchange Act of 1934, which created the SEC as the centerpiece of an effort to prevent a repeat of the 1929 market crash.

With the go-go 1990s a fond memory, politicians responded to public clamoring for a corporate crackdown, something to dissuade future Enrons from happening. They produced a set of rules whose main provisions aimed to hold CEOs and CFOs more accountable for their firms' financial disclosures, required more thorough reporting programs, and established stricter standards for membership on board audit committees. There also was the creation of a new oversight board to monitor the accounting industry. Underlining all of it were hefty doses of new criminal penalties — fines of $5 million and 20 years in prison for executives who knowingly certify false financial reports. (Richard Scrushy, the first CEO to be prosecuted under Sarbanes-Oxley, was acquitted June 28 after three weeks of deliberation.)

The reforms came at a time when the country was coming out of recession and less than a year removed from the terrorist attacks of Sept. 11, 2001. At the same time, stock exchanges were toughening their rules for listing, civil lawsuits were mounting, and the criminal justice system was stepping up, as perp walks featuring former Wall Street darlings became commonplace.

To some economists, Sarbanes-Oxley was an unnecessary pile-on. Disclosure is often in the best interests of businesses, since firms that fully disclose their information may command higher share prices for their stock. Disclosure, many academics agree, potentially reduces the age-old agency problem inherent in large organizations whose owners are not necessarily the same as their managers. In this way, shareholders are better equipped to keep an eye on managers, making sure they are doing what they were hired to do: increase the firm's share value.

Disclosure also takes the edge off of adverse selection in capital markets — if all investors are equally and well-

SARBANES-OXLEY ACT OF 2002

To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED. The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING. With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

informed, then fewer will buy shares in firms that ought to be avoided. But in Sarbanes-Oxley, the government was essentially saying that new measures were necessary to reel in agency costs.

Whether Sarbanes-Oxley has actually succeeded in easing the agency problem remains up for grabs. Disclosure does not automatically rid the world of fraud. Companies could meet all of the law's disclosure requirements but still file fraudulent reports. In addition, an economically rational world seeks to "keep on spending on fraud prevention until the returns on a dollar invested in prevention are no more than a dollar," says William Carney, a law professor at Emory University who is studying the costs of being public after Sarbanes-Oxley. In other words, wiping out all fraud would be prohibitively expensive. You don't want it to cost more to prevent fraud than the fraud itself would have cost in the first place. Better, Carney says, is to strive for an "optimal amount of fraud." And he is very skeptical that Sarbanes-Oxley has brought us anywhere closer to achieving optimization. Sarbanes-Oxley, Carney writes, "may have reached the point where the costs of regulation clearly exceed its benefits for many corporations."

Numerous surveys have tried to nail down the new costs of complying with Sarbanes-Oxley. Foley & Lardner, a Chicago law firm, found in 2003 and 2004 that the average cost of being public for firms with annual revenues less than $1 billion grew $1.6 million, or 130 percent, since Sarbanes-Oxley took effect. In a different survey of larger firms, Financial Executives International reported that Section 404 compliance clocked in at an average $4.36 million per firm, which was 39 percent higher than surveyed firms had originally expected to pay.

If rising costs persuade large numbers of firms to exit the public markets to evade SEC regulation, two distinct problems are created. First, the overall economy might suffer insofar as firms may give up investment projects because they may have to rely on higher-cost sources of capital to fund operations. Second, firms that "go dark" may happen to be the very sort of financially stressed organizations which shareholders might want closer tabs on — the very sort of companies Sarbanes-Oxley was designed to police.

(A counter argument is that a "dark" Enron would never have been able to raise as much capital as it did; in this way, the trend of troubled firms going dark may not be such a bad thing because shareholders wouldn't be funding the new capital by buying up stock.)

Going dark is probably the most extreme reaction to climbing compliance costs. Among the main requirements for being able to deregister is having fewer than 300 (sometimes 500) shareholders of record. It can be a quick process. When S&K delisted, for example, it needed only to provide written notice to Nasdaq of its intent to delist and then file a Form 15 with the SEC. With that, all obligations to operate under the auspices of the SEC ceased and S&K — or any other deregistering organization — could join the Pink Sheets, an automated quotation service known informally as an over-the-counter bulletin board. This is the land of no-name stocks, firms which are longest-shot candidates to grace the covers of *Fortune* and *Forbes*. Inevitably, firms that go dark see their stock prices fall, a function of both the Pink Sheets' looser listing requirements and the relative lack of liquidity compared with the Nasdaq or New York Stock Exchange.

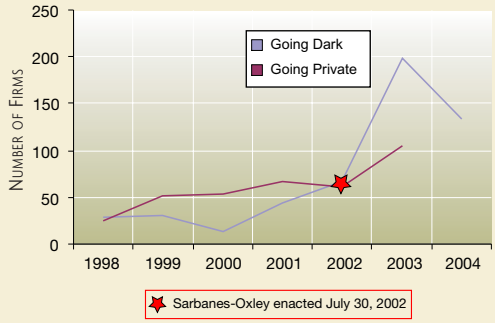
People started to notice a spike in "going dark" maneuvers shortly after Sarbanes-Oxley went into effect. In the summer of 2003, some institutional investors filed a petition arguing that many firms going dark were unfairly taking advantage of the 300-shareholder rule. It was alleged that many of these firms actually had thousands of shareholders, but because their stock was held by a relatively small number of brokerages and other institutions, the delisting firms could point to less than 300 holders of record. Three business school researchers took notice of the petition and decided to investigate further. "In the back of our minds was that maybe Sarbanes-Oxley was responsible for this," says Alexander Triantis, a University of Maryland business professor and co-author of the paper "Why Do Firms Go Dark?"

Just as they suspected, the authors found that the number of firms that went dark surged sharply after the enactment of Sarbanes-Oxley: from 43 in 2001, to 67 in 2002, and then way up to 198 in 2003 (see table). Because figuring out who's going dark requires combing through SEC filings, 2004 numbers were still being tallied this spring, but the researchers estimate that 134 companies delisted in 2004, still far above the pre-Sarbanes-Oxley pace.

An examination of going-dark filings among firms with headquarters in the Fifth District is inconclusive, mainly because of the small sample size. In 2001, six Fifth District firms filed to go dark; in 2002 it was down to four but in 2003 the number jumped to 10. The pace slowed to six going-dark filings in 2004. In a fairly typical announcement just before its 2003 deregistration, Maryland-based International Dispensing Corp. said it expected to save up to $190,000 a year: "The company believes that the cost savings of terminating reporting obligations far outweigh the benefits of maintaining the company's status as a Securities and Exchange Commission reporting company."

The SOX Spike

Two studies have attributed an increase in the number of firms going dark and going private to the July 2002 enactment of Sarbanes-Oxley.



NOTE: Engel, Hayes, and Wang provide data for going-private firms through 2003 only.
SOURCES: Leuz, Triantis, and Wang (2004) and Engel, Hayes, and Wang (2004)

Triantis describes the national delisting trend as "consistent with a Sarbanes-Oxley effect but not completely conclusive." Firms may be going dark for completely sensible, above-board reasons — that is, the benefits of SEC listing are now swamped by the costs due to Sarbanes-Oxley. Most firms that go dark are described in their paper as distressed and small. By delisting, even factoring in the usual 10 percent stock price dip, firms are making an economically rational choice that may benefit shareholders over the long term.

The more negative interpretation has it that the firms' managers are thinking more about their own interests than that of other shareholders. They want to protect themselves from liability, and to continue using their companies as their own private piggy banks, keeping their jobs and increasing their compensation.

"We think Sarbanes-Oxley definitely has to be driving some of this," Triantis says. "Whether that's simply due to the cost of Section 404 that all these firms are complaining about or whether it's the increased scrutiny and liability that managers want to avoid — that's a little harder to determine."

From High Flyer to Low Profile

S&K is a virtual case study of the going-dark decision. Here is a company with an almost mythical-sounding beginning. As told on the S&K Web site, the company opened in 1967 when founder Hip Siegel loaded up his station wagon with discounted suits from department stores, then resold them at a profit. The operation grew to 10 stores by 1983, the year it first offered shares to the public. With the money raised, S&K immediately doubled in size and kept a consistent growth pattern through the early 21st century, today peaking at 240 stores.

Stuart Siegel, Hip's son, soon took over as chairman. He is a well-known figure in Richmond, a philanthropist whose home was recently featured in the local newspaper. Only four years ago S&K cracked *Forbes*' list of "200 Best Small Companies," landing at exactly No. 200. At the time, despite the business-casual trend of dress, it was coming off five years of strong profit and sales growth. Then in early 2004, it retired almost all of its debt, making for a healthy balance sheet.

But for all the growth, the market was no longer rewarding S&K as before. S&K's book value — essentially, what it would be worth if it sold off all its assets — was $20 a share, higher by several dollars than the typical trading price in 2003 and 2004. Two years ago, the last two analysts covering S&K stock dropped their coverage, leaving investors with fewer options for independent scrutiny of the company's earnings prospects. Trades of S&K stock grew rarer and rarer, making it more difficult for owners to sell at a profit. With a market capitalization of less than $50 million, S&K was known as a small-cap stock, barely a blip on Wall Street's radar screen.

Then came Sarbanes-Oxley. At first, S&K's Knowles was optimistic. He thought firms like S&K, with no history of governance problems and decent growth prospects, would see their stock prices climb along with a boost in investor confidence. His mood turned sour when the implications of Section 404 became clear.

S&K was caught in the unfortunate position of being both small in terms of financial resources but big in terms of the breadth of work needed to comply with Sarbanes-Oxley. Section 404 mandates a thorough, independent review of a firm's internal financial reporting practices. For S&K, the manpower and the costs involved in compliance were overwhelming. "We have cookie-cutter stores, 240 different sites, over 1 million square feet in 27 states," Knowles says. "Yet we would have to document all that from a representative sample of all those stores and have people who don't know menswear from a tree go in there and try to document and then audit it. And what benefit can possibly come from that?"

Knowles adds with exasperation, "It's like putting on three or four extra seatbelts."

S&K opted to remove those perceived extra seatbelts. The choice prompted the aforementioned stock drop, but has had little other negative impact, Knowles says. The Pink Sheets provide an adequate trading ground for S&K stock. And S&K will continue posting its financial results on its Web site, still have everything audited, and look to continue its growth strategy and reward shareholders. The only difference, Knowles insists, is that S&K won't be following Section 404. "The job is basically the same," he says, referring to his post as chief financial officer. Meanwhile, S&K's stock was trading about $17 a share going into the summer, close to its pre-Pink Sheets price. All things considered, not bad for a dark company.

A Little Privacy

Going dark is not to be confused with going private. A "dark" firm still trades among outside investors. A firm that goes private keeps its stock closely held. A public company can become private in several ways, with the most common methods being a merger with a shell company, a tender offer to purchase shares from other stockholders, or a reverse stock split that reduces the number of shareholders of record to less than 300. In general, it's a bit harder to go private than dark, and sometimes requires a lot more money.

A growing literature posits that many small and midsize firms ought to consider abandoning the public markets. Skyrocketing compliance costs are only one part of the puzzle. These days, smaller public firms experience serious liquidity issues anyway, trading with nothing like the regularity and smoothness of S&P 500 firms. This reduces the presumed advantage public companies have in selling stock quickly and easily.

Besides ditching the costly trappings of Sarbanes-Oxley, private companies get to keep more of their financial information out of reach from competitors. Additionally, private sources of capital — though

generally more expensive than public sources — are growing, which means that being private is a less significant barrier to expansion than before.

More intangible but with a potentially greater payoff is the effect going private has on agency costs. Suddenly, the interests of managers and owners are aligned more than ever in a private structure. Instead of gunning for short-term gains that might in the long run hurt shareholders (e.g. Enron, WorldCom), managers of private firms are free to pursue whatever is best for the company. (Going private is not necessarily a new trend; the reduction of agency costs was one of the reasons behind the leveraged-buyout craze of the 1980s, a movement led by players like Kohlberg Kravis Roberts.) Joseph Fuller, CEO of consulting firm Monitor Group, wrote in a 2004 article that obituaries for the public company structure may be a bit premature. "Still," he added, "the form is showing its age and vulnerability."

Sarbanes-Oxley has brought that observation into clear focus: Firms are going private at a faster clip in the wake of the new law. In a 2004 paper, three University of Chicago researchers added up 93 firms that filed to go private in the 19 months before Sarbanes-Oxley was enacted and 142 going private in the 19 months after (see table). Rachel Hayes, an accounting professor and co-author of the study, described that as a "modest increase." Hayes says it's possible that the increase is partly cyclical in nature, but that her study mostly seems to point to a combination of market conditions and the effect of Sarbanes-Oxley as making "going private more attractive."

A Fifth District examination of going-private transactions is, as with the going-dark case, inconclusive because of the small sample size. There were seven going-private filings among Fifth District firms in 2001, four in 2002, a small jump to seven in 2003, and then six in 2004. North Carolina's Quintiles Transnational Corp., a drug-testing company, served up one of 2003's biggest going-private transactions when a group led by the firm's chairman bought it out for about $1.7 billion. The complaint voiced in a Wilmington, N.C.-based Reeds Jewelers Inc. announcement in early 2004 was representative of the going-private mood: "Operating as a privately held entity will enable Reeds to reduce certain costs related to being a public company, including, among others, legal compliance costs."

Darlington County Bancshares, one of the smallest banks in South Carolina, saw its stock price struggle for years before directors decided to go private.

As with going-dark firms, a theme with the recent spate of going-private firms is their size: They're small. After the enactment of Sarbanes-Oxley, the average size (by annual sales) of firms going private was $74 million. And that was less than half the size of the typical firm going private before the new law, when the average was $170 million in annual sales. (For comparison, consider that cracking the Fortune 500 requires at least $3.6 billion in annual sales.)

Although Hayes is comfortable noting the modest increase in going-private transactions since Sarbanes-Oxley, she is not so certain about drawing larger conclusions. "It's so hard for us to look at our data and say these guys would not have gone private otherwise," she says. "It's very possible a lot of these would have gone private anyway."

Never a Darling

Henry Funderburk is candid about the very real possibility that his bank might have gone private anyway. Darlington County Bancshares, one of the smallest banks in South Carolina, executed an odd-lot tender offer that brought its number of shareholders to 278, spending about $175,000 to purchase the stock of people owning less than 100 shares.

Darlington Bank wasn't even listed on a stock exchange to begin with. If a shareholder wanted to sell some stock, bank management would put them in touch with a potential buyer, and vice versa, referring to a list kept at the bank's only office. But since it used to have more than 300 shareholders, Darlington did have to file the usual 10Ks and 10Qs with the SEC. After Sarbanes-Oxley, that meant spending money on a new auditor to review controls that were already reviewed by multiple bank officers and regulators.

Banks are unlikely suspects for stepped-up regulation. "The irony is that these institutions were already highly regulated, with records scrutinized by government officials as well as their own auditors," says law professor Carney in his paper "The Costs of Being Public After Sarbanes-Oxley." All that work reporting to banking regulators is, unfortunately, not entirely transferable to SEC reporting requirements; everything must be documented consistent with Section 404's unique standards. Referring to a finding that 15 percent of all going-private filers in 2004 were banks, Carney says: "Surely investors and depositors in these communities will not feel better off because of these developments ... Say good-bye to the community bank that was owned by the community."

Even though it's now private, Funderburk's organization remains subject to heavy regulatory scrutiny, since it's a bank. "We still have to comply with everything," he says. "We just don't have to do the reporting." And because of that, the bank figures to save $100,000 a year in auditor fees.

That is a lot of money for Darlington Bank, whose 2004 net income was just $343,000. Funderburk says Sarbanes-Oxley "gave us a final push" but admits that going private was something the

PHOTOGRAPHY: DARLINGTON COUNTY BANK

bank's directors had been considering for years, anyway. Not even listed on a stock exchange, what sort of benefits was Darlington reaping from being public?

As it happens, that's the same question directors at S&K Famous Brands had been asking themselves for some time. Karen Newman, an S&K director and former dean of the business school at University of Richmond, says that when she took her seat on the board in the spring of 2004, discussions were already happening about how to deal with S&K's lifeless share price. Sarbanes-Oxley, Newman says, was "the straw that broke the camel's back."

Whether going dark is merely a stepping stone to going private or a way station before returning to SEC supervision depends as much on economic conditions as it does on Sarbanes-Oxley. CFO Knowles says that returning to the Nasdaq might very well be in S&K's future.

For now, low interest rates make bank debt more desirable than raising capital through the equity markets, he says. So long as S&K's operations and strategic growth can be funded through loans, then there's no rush to return to the Nasdaq. That said, Knowles adds that any reforms by the SEC to make Section 404 less burdensome for smaller firms would change that formula. "There's no question we would reconsider listing if the small-firms issue was addressed," Knowles says. "I liked the idea of being on the Nasdaq. It carried a lot of clout."

A SOX for Small Firms?

Overwhelmed with complaints about Section 404, the SEC has taken notice. This spring, the commission for the third time extended the deadline for smaller public firms to comply with Section 404. And there is growing support, even among some lawmakers, for softening Sarbanes-Oxley rules when it comes to small companies.

For the few hundred firms that go dark to evade investor scrutiny, "Sarbanes-Oxley has certainly not served investors," says Triantis, the University of Maryland professor. But he is not rushing to entirely dismiss Sarbanes-Oxley as ineffective. Despite the backlash, most firms are not straying from the public markets or going dark.

Triantis says there are "hundreds of firms that could deregister that don't and many more that have 300 or more shareholders that could get below that, so we're not talking about thousands of companies." Additionally and even more persuasive, is an easily overlooked finding in his study: The negative stock slides of going-dark firms have been worse since the passage of Sarbanes-Oxley than before. To Triantis, that means the market is placing a higher value on disclosure, which by extension ought to lift share prices for firms that remain SEC-compliant.

Robert Litan, senior fellow in economic studies at the Brookings Institution, says that disentangling the impact of Sarbanes-Oxley from other concurrent developments is difficult. Perhaps it did have the effect of restoring investor confidence in the markets, but then again what about the role of the criminal justice system, which responded more aggressively than Litan had expected? Or the clamping down of the New York and Nasdaq stock exchanges, beefing up requirements for membership? Or mounting civil lawsuits against alleged wayward executives? "You could argue that the deterrent effect of [those things] alone could have accomplished all the benefits being claimed to Sarbanes-Oxley," Litan says. "Much of this might have happened without Sarbanes-Oxley."

Sarbanes-Oxley is, of course, named after its sponsors: Sen. Paul Sarbanes, a Maryland Democrat, and Rep. Michael Oxley, an Ohio Republican. Many analysts and observers credit the pair's legislation with a renewed emphasis on good corporate governance that has restored integrity and trust in U.S. firms.

In a 2004 press release on the two-year anniversary of Sarbanes-Oxley, Sen. Sarbanes summed up the case for the legislation that bears his name: "I believe that we have succeeded in raising standards," he said, "with increasing international support, to give investors a new degree of confidence in our capital markets." Still, there are dissenters. Over at S&K headquarters, CFO Knowles notes that Sarbanes is retiring after his current term expires in 2006. It's an open question whether S&K stock can hold up that long in the dark. **RF**

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Tobacco Buyout

The invisible hand plants first crop

BY BETTY JOYCE NASH

Kent Hudson has bumped along tobacco road for 35 years, jumping at opportunity here and there.

"It's like rolling logs on a river: You got to be steady on your feet and be ready to change directions," he says. Hudson gave up growing tobacco in 1993 on his farm in the Piedmont near Buffalo Junction, Va., about a mile from the North Carolina line, midway between the mountains and the sea. He's sold harvesters, planters, and tobacco barns. More recently, he's been loading up 10- by 30-foot metal tobacco barns and hauling them from the Piedmont into the coastal plains of the Carolinas. That's because tobacco production is headed east for big, flat plains where efficiency rules.

Competition is coming to tobacco fields as growers try the free market. The federal tobacco price support and quota program ended last fall by congressional legislation. Hudson's new moving business bears out economists' predictions that tobacco farming will migrate, for efficiency's sake, to fields where topography enhances instead of hinders production. "Those that are quitting are selling the barns, and the people expanding are buying them," he says. That pretty much sums it up.

Under the legislation, tobacco growers and quota owners will receive $9.6 billion over 10 years, an effort to pay them for an asset — the right to grow tobacco — created more than 70 years ago by the federal tobacco program during the New Deal. (Another $500 million will go toward disposition of tobacco held by grower associations.)

Ed Young's family has raised tobacco in South Carolina since the 1800s. Young oversees planting of the first crop grown since the 1930s without price supports.

PHOTOGRAPHY: BETTY JOYCE NASH

The new law lifts restrictions on location, size, and amount of tobacco production, leaving the market to decide who grows tobacco best.

Tobacco in the Fifth District

Tobacco has been a cash crop since 1612, with flue-cured the most common type produced in the Carolinas and Virginia. Flue refers to the curing process, which uses forced air heat that was once circulated through a flue in the barn.

The biggest chunk of the nation's $1.75 billion 2004 tobacco receipts went to North Carolina: $652 million. Kentucky ranked second, Virginia was third with $127 million, and South Carolina, fourth with almost $110 million. Even Maryland, which bought out all but about 150 growers five years ago, raked in some $3 million in 2004 tobacco cash, as did West Virginia. But antismoking sentiment and declining demand, falling exports, and competition from imported leaf had led to severe quota cuts over the past few years. Without price supports, the market might have sorted itself out years ago.

"Tobacco has been the backbone of agriculture in Southside Virginia for many, many years," says tobacco specialist Stan Duffer of the Virginia Department of Agriculture and Consumer Services. "People knew how to grow tobacco. Now, we're in a different time. Here in Southside

you'll see some increase in livestock, beef cattle. It'll go back to supply and demand, I can assure you."

Controlling supply was the cornerstone of the federal tobacco program.

"The idea in economic terms is to restrict aggregate supply and hope you raise the price some," says Blake Brown, an economist at North Carolina State University who studies tobacco. The restrictions on many crops didn't endure like those on tobacco because of international competition. "But with tobacco, the international competition didn't become intense until the late 1980s and early 1990s." And when competition intensified, the price support program hamstrung tobacco farmers' ability to compete.

In the 1930s, farmers got quotas based on growing history. Tobacco quota became an asset. To expand, farmers either bought land with quota, rented land with quota attached, or bought quota and attached it to land. The buyout pays quota owners $7 a pound over 10 years based on 2002 basic quota. Meanwhile, producers who raised tobacco in 2002, 2003, or 2004 will be paid $3 per pound over 10 years if they grew tobacco all three years. Those who grew tobacco only one or two of those years will receive proportionately smaller payments. About 416,000 growers or quota owners are out there. The Environmental Working Group, a nonprofit that investigates farm subsidies, reports the average payment will be around $4,396. But about 462 people, estates, or corporations will average about $1.6 million apiece, according to the group's calculations.

Buyout money will be paid in 10 equal annual installments — for instance, for 500 pounds, a quota owner would get $350 annually — or farmers may choose other payment options through financial institutions. (This bigger pot of money replaces the rest of the Phase II funds, about $2.5 billion of the original $6 billion, scheduled for growers and quota owners under the Master Settlement Agreement of 1998.)

Wachovia Corp. won a contract from the U.S. Department of Agriculture to mount a public information campaign to make sure tobacco farmers and quota owners know the ins and outs of the deal. The anticipated buyout money has uncorked a stream of financial planning seminars and charitable giving suggestions.

That's because payments, including those to Fifth District states, will be substantial: Growers and quota owners in North Carolina will receive about $3.9 billion; South Carolina, $724 million; and in Virginia, they will get almost $667 million. Manufacturers and importers will foot the bill based on market share. (The three largest tobacco firms are in the Fifth District and include Philip Morris USA of Richmond, Va.; R.J. Reynolds Tobacco of Winston-Salem, N.C.; and Lorillard Tobacco Co. of Greensboro, N.C.)

It was essential to compensate quota owners, Brown notes. "You've created an asset with value whether you intended to or not," he says, adding that the original laws created the expectation that quota would continue to be valuable.

The buyout money will allow farmers with inefficient farms or without successors to retire, Brown says. (The average age of tobacco farmers is about 55.) Others will use the money to pay off debt. Some may develop businesses or retrain. Whether buyout money will stay local and work for these rural communities when farmers abandon tobacco, though, is unclear. "What you would hope is that quota owners who had been using quota rent as an income source will invest and if they make wise investments, the income will come back into these local communities to replace quota money," Brown says.

Out of Kent Hudson's five nearby neighbors, four quit. One will expand his road construction business, another bought a dump truck, another will add to his cattle herd, and another will work for the neighbor who is in the construction business. The loss of the tobacco crop will have an "effect on the car dealer, the pickup truck dealer, the fertilizer people, and the equipment people," Hudson says.

Tobacco Tradition

Heading east on U.S. 176, just off Interstate 95 in Florence, S.C., there's an elegant white-columned home that dates from 1877. It's Ed Young's farm and he's the third generation to work that land. He still sleeps in the same bedroom where he was born. Young is 84 and aptly named because he climbs in and out of his big cab pickup truck easily in spite of a recent hip replacement. On a windy day in late April, Young stands in a field of about 32 acres. A carousel planter, named for its rotating part that deposits tobacco seedlings, crawls along. There are typically 6,000 plants to the acre on these South Carolina fields of sandy loam. Young should know, as his family has grown tobacco here since the late 1800s. Young's uncle met with Franklin D. Roosevelt before the president created the tobacco program.

This year, Young planted the same amount of acreage in tobacco under these new market conditions as he did last year under the old quota system, 65 acres compared to the 100 or so he planted three years ago. He is waiting to see what changes the market brings.

"I'm gonna take a chance," he says. "We have a contract with Reynolds." R.J. Reynolds Tobacco Co. is the nation's second largest tobacco company, with about one-third of the domestic cigarette market, behind Philip Morris USA, with about half the domestic market.

This year, tobacco growers without contracts with manufacturers or leaf merchants aren't likely to plant. The contract system replaced the outdated auction warehouses several years ago. The Reynolds contract instructs Young and other growers in his area to ditch the bottom (less valued) eight tobacco leaves of the tobacco plant's 19 leaves, which will cut the yield by 20 percent, Young says. Some farmers chose not to plant because they didn't think they could make money. Dewitt Gooden, tobacco specialist with Clemson University, reckons that this year there'll be about 25 percent less tobacco planted in this region compared to last year.

Young would like to expand, if the market warrants. His children, grown and far-flung, are unlikely to carry on farming. Raw land near his farm sells for $20,000 an acre, and substantial subdivisions are plopped down adjacent to fields. "It's hard to farm land worth $20,000 an acre," he says.

Tobacco contract prices, says Blake Brown of N.C. State, have fallen by the amount of the quota rent — about 40 cents to 50 cents a pound. The farmers with the most competitive yields will make money; others will not. Field size, fixed costs, equipment costs, labor costs, and good management will determine profitability, like any other business, says Brown. But the single biggest factor to success is the productivity of the land itself.

Oversupply from last year's crop kept contract amounts low this year, says Jim Starkey, senior vice president of Universal Corp., based in Richmond, one of the biggest leaf merchants in the world. Without production limits, the better farmers will grow more under contract, Starkey says. Taking the quota price out of the equation removes a nonproductive cost from the system, he notes.

"What a grower actually receives will depend on what he actually produces in a given year," Starkey says. "If he has a good year and produces a higher quality tobacco, his income will go up."

Even though production of flue-cured tobacco will increase in the coastal plains, there will be some tobacco grown in the Piedmont, Brown says. That's because buyers like to spread risks and avoid weather extremes or other possible production problems. Jim Starkey says Universal has contracts in all five flue-cured producing states. Some flue-cured tobacco farmers will try growing burley tobacco now that there are no restrictions on where certain tobaccos can be grown. Burley was traditionally raised on the fringes of the Appalachians. Burley is labor-intensive and grown in a slightly cooler climate than flue-cured. The entire stalk is cut, hung, and air-cured. Starkey says humidity prevents burley production in the tropics, the source of most international tobacco competition.

"In the case of burley, I think the core will still be in Kentucky and Tennessee, but since so many growers will be getting out of the burley production area, I think we'll start to see that production move to new areas and the Piedmont is one," Starkey says. Most mountain burley growers will quit tobacco because the steep terrain and small plots curtail efficiency. Without the guaranteed tobacco price, they won't make money. Some growers in the Piedmont are planting burley, but, of course, it's untried and risky.

Ed Young watched his father turn to dairy after the boll weevil wiped out cotton. He's lived to see cotton revive and dairy production move on to greener pastures. He plans to invest in equipment and perhaps in another farm. Other farmers in his neighborhood are putting land in timber or trying new agricultural enterprises. As for the rest, the money greases the way out. **RF**

Maryland Tobacco Settlement Payments in Limbo

Most of Maryland's tobacco farmers agreed to a buyout in 1999, when the state pledged to use money from the Master Settlement Agreement's Phase II to compensate them for getting out of tobacco. But those payments ended when the tobacco buyout legislation was passed last fall, leaving Maryland farmers in the lurch.

Maryland farmers opted out of the federal price support system in the 1960s; none will receive money from the current federal buyout program. Pennsylvania tobacco farmers are in the same boat, since they also did not participate in the federal tobacco program.

"We had roughly 1,000 individuals receiving payments from the trust whose payments are now in jeopardy," says Patrick McMillan, an assistant secretary of the Maryland Department of Agriculture. Maryland farmers had seven payments remaining, worth a total of about $12 million.

Farmers covered by the Master Settlement Agreement have not received money for 2004 because tobacco companies say they're not obliged to make that payment now that the buyout has replaced the Phase II schedule.

The matter is now with the North Carolina Supreme Court. Original trust papers gave the North Carolina courts jurisdiction in tobacco settlement matters. "[Growers] are losing this stream of revenue they anticipated when they made their decision," McMillan says. "It's very unfair to them."

Farmers participating in the Maryland program are paid $1 per pound annually over 10 years, based on the average amount of tobacco produced between 1996 and 1998. In exchange, farmers agreed to quit growing tobacco and use the land to grow other crops for at least 10 years. By 2005, 86 percent of producers were taking the buyout.

Maryland tobacco farmers have always been a different breed: They grew the unique Type 32, known for slow and even burning.

The tobacco was sought after in the European market and prices over the years were strong. And domestic firms bought the grades the Europeans didn't want. That's probably one of the biggest reasons why Maryland farmers decided to get out of the federal program, says David Conrad, regional tobacco specialist with the University of Maryland's cooperative extension service. "When you put those prices [domestic and European] together, there was no need for price supports," he says. — Betty Joyce Nash

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REDEVELOPMENT BOOT CAMP

To survive the latest round of base realignments and closures, military-centric communities will have to find ways to turn barracks and bombing ranges into something marketable BY CHARLES GERENA

A talkative group fills the restaurant booth near the front door of Ida's Kitchen. They chew the fat about the latest movies and exchange neighborhood gossip while a gray-haired lady listens quietly from a chair pulled up beside the booth. She is the owner of the establishment, which provides catering services throughout rural Southside Virginia as well as a hot platter of Southern cooking for walk-ins.

Right away, two things stand out. Only one man is seated at the booth, and he is dressed in the camouflage colors of an Army National Guard uniform. Actually, there is something else different. The long, flat building looks like it belongs on an Army base. In fact, Ida's operates in what used to be a mess hall that fed soldiers stationed at Fort Pickett. Outside, C-17s practice sorties at a nearby airfield four times a week. Sometimes, they fly so low that a passing motorist can almost make out the pilot's face.

Fort Pickett covers 42,000 acres, making it larger than Washington, D.C. The vast facility's economic influence spreads even farther, encompassing the small town of Blackstone and surrounding Nottoway County. Both fared OK after Fort Pickett landed on the Base Realignment and Closure (BRAC) list in 1995. The facility was taken over by the Virginia Army National Guard, which manages it pretty much as the U.S. Army did for more than 50 years.

"The military presence continues, and thank goodness for that," says Joe Borgerding, a bank manager in Blackstone who recently served on the board of the local chamber of commerce. And a small section of Fort Pickett made available for private development has supported some economic activity, mostly small businesses like Ida's Kitchen.

Other localities in the Fifth District lost military installations during the four previous BRAC rounds between 1988 and 1995, but they were spared the major closures that shook up communities in states like California. (The big exception was the shutdown of the Charleston Naval Complex, which cost the South Carolina city thousands of jobs.) In fact, a few places like Naval Air Station Patuxent River in southern Maryland and Marine Corps Air Station Cherry Point in eastern North Carolina enlarged when they received personnel from closed facilities.

The Fifth District may dodge the bullet again. Fort Monroe in Hampton, Va., was the only major installation targeted for closure when Defense Secretary Donald Rumsfeld announced the preliminary 2005 BRAC list in May. And Naval Station Norfolk in Virginia, Fort Bragg in North Carolina, and other

Most of Fort Pickett, which covers more ground than the nation's capital, was retained by the military rather than redeveloped.

PHOTOGRAPHY: COURTESY OF FORT PICKETT

facilities could end up with a net gain in employment once the dust settles. But a nine-member commission can modify Rumsfeld's list before they present it to President Bush for his consideration in September. Until then, every community with a major military presence faces an uncertain future.

It's hard to generalize about how well they will fare judging from Fort Pickett's experience alone, especially since the installation was "realigned" instead of closed. But the effects of previous BRAC rounds on communities like Blackstone and efforts to mine the economic potential of military installations like Pickett offer some important lessons. Most importantly, the odds of success increase when redevelopment complements what the local community already does well.

"Rome wasn't built in a day, and you aren't going to redevelop bases in a day either," advises William Harvey, former chief of the Army's BRAC office and president of an Alexandria, Va., consulting firm that helps redevelop federal property. "The time [required] is based on the area's absorption capability and the demand for that type of property."

Being "Brac"-ed

Before the release of the initial 2005 BRAC list, news stories appeared with ominous headlines like "Base Closings Will Hit Like Tsunamis." Past experience doesn't justify this level of pessimism.

A recent analysis by the U.S. Government Accountability Office found that about 85 percent of local civilian jobs lost during previous base closures have been replaced through the development of the properties. "Two key economic indicators — the unemployment rate and the average annual real per-capita income growth rate — show that BRAC communities are generally doing well when compared with average U.S. rates," the report states.

Other research has found that, in the aggregate, the economic effects of a base closure don't spread far beyond the immediate vicinity over the long run. Even then, the ripples rarely become the tsunamis that people predicted.

One of the researchers who reached this conclusion is Ted Bradshaw, a community development expert at the University of California-Davis. "If you are losing a base [that] has thousands of people, you cannot assume that your economy is going to go down the tubes," he says. "You don't have that local customer base [anymore], but the net effect over a number of years is going to be possibly neutral or positive."

For individual communities recovering from a closure, though, the short run can be painful. "The recovery process has not necessarily been easy, with the strength of the national, regional, and local economies having a significant bearing on the recovery of any particular community facing a BRAC closure," noted the 2005 GAO report.

The shutdown of a military installation tends to hurt rural communities more than urban locales. Bradshaw and others say that's because such facilities account for a relatively large share of employment and spending in an economy with a relative lack of business diversity. The impact of a closure also depends on the type of installation, which determines how much of its payroll and procurement dollars are spent locally. (See the cover story, "Dollars and Defense," in the Summer 2003 issue of *Region Focus*.)

The Army built Fort Pickett during World War II to prepare Army soldiers and reservists for battle. Tens of thousands of these warriors spent money locally during their stay, while the facility employed hundreds of civilians to maintain the grounds and purchased some supplies locally. Fort Pickett revved up again during the early 1950s to prepare soldiers for combat in North Korea, then evolved into a transient facility for training armed forces.

Fire Sale

With the potential negative effects of a base closure on a local community come the potential benefits of freeing up military real estate for civilian use. For installations where urban development encroaches upon its borders and land is at a premium, their property could prove very valuable. In fact, the city of Concord, Calif., lobbied for the closure of a naval weapons station in the next BRAC round so that land would be available to meet the soaring demand for residential development in the hot Bay Area housing market. (They got their wish.)

In some cases, the traits that made former bases attractive to the military are also conducive for civilian applications. For instance, naval facilities could be well suited for port operations, while other installations with aviation infrastructure could support commercial air traffic or house a plane maintenance facility.

However, there are costs involved in realizing the potential value of a military installation, some of which are borne by the Defense Department and some of which fall on other people's shoulders. Depending on the desirability of the site, these expenses may make it difficult for developers to get a good return on investment. "Where there is the will, there is a way ... and where the economics support it," notes consultant Bill Harvey.

President Bush recently proposed converting bases into oil refineries. The permitting process for such conversions might be easier compared to building a refinery on a virgin site. But energy analysts note that many bases aren't near existing pipelines or large bodies of water that are accessible to oil tankers, plus they may be too contaminated for refiners to deal with cost effectively.

Long Recovery

Only two of the five major base redevelopments in the Fifth District have managed to produce enough jobs from private-sector investment to replace the civilian jobs lost post-BRAC.

	Loss	Gain
Charleston Naval Complex, SC *(BRAC 1993)*	6,272	2,797
Fort Pickett, VA *(BRAC 1995)*	245	272
Fort Ritchie, MD *(BRAC 1995)*	1,373	42
Myrtle Beach Air Force Base, SC *(BRAC 1991)*	784	1,571
Vint Hill Farms Station, VA *(BRAC 1993)*	1,472	901

SOURCE: Office of Economic Adjustment, U.S. Department of Defense

Indeed, many military installations have problems similar to brownfields. "They have major toxic conditions [in soil and groundwater] that have to be remediated," notes Debbie Kern, a San Francisco-based real estate consultant who specializes in base conversions. Additionally, installations usually have at least some buildings and infrastructure in need of upgrading or replacement. On top of these brownfield issues, installations may have unexploded bombs and other munitions that defunct industrial sites don't have.

All told, dealing with these issues takes a lot of time and resources. Unless it does an early transfer, the Pentagon usually doesn't turn over an installation until it is suitable for civilian use. That can take decades, according to Kern, depending on the amount of remediation and infrastructure work required.

Nottoway County was fortunate because much of the infrastructure in the 1,654 acres of Fort Pickett transferred to its Local Redevelopment Authority was in good shape. The utilities had been operated by outside entities before Pickett's realignment, and the Army did some repair work on water and sewer lines before the land transfer. Three buildings transferred for redevelopment were demolished, but others were in good shape and the Army repaired a few beforehand. Consequently, many structures are being reused as is, from a bowling alley to a chapel run by a former Pickett commander.

In addition to the remediation and infrastructure work that may be required before a military installation is ready for transfer, there is the transfer process itself. First, the Pentagon sees if it can use any of the property. Whatever it considers to be excess is then up for grabs by other federal agencies. Any land remaining is declared surplus and signed over to new owners, either through a direct sale or a variety of conveyance mechanisms.

In Fort Pickett's case, Nottoway County received its chunk of the facility for free under an economic development conveyance, which Kern says is a somewhat expedited process. Still, it took five years for the transfer to be completed.

Private vs. Public

Given the pecking order of base reuse, how much land ends up in private hands and how much of it gets gobbled up by Uncle Sam first? More than half of the property declared unneeded in four previous BRAC rounds — 450,000 acres, to be exact — has been retained by the Defense Department for reserve and National Guard units, or transferred to another federal agency thus far. Only 31 percent, or 264,000 acres, has gone to new owners outside of the U.S. government, including local redevelopment authorities and private developers. (See chart.)

Fort Pickett was supposed to be mothballed. That didn't happen due to lobbying by officials like the late U.S. Rep. Norman Sisisky to have the Virginia Army National Guard take over management of most of the facility. Also, then-Gov. George Allen lobbied for state officials to move the Department of Military Affairs, which oversees the state's National Guard operations, to Pickett.

Although the 1995 BRAC report noted that Fort Pickett was "low in military value compared to other major training area installations," the Pentagon reportedly decided that the Virginia Army National Guard could run it at a lower cost than the regular Army could and still train troops throughout the Mid-Atlantic.

Today, about 900 military personnel, civilians, and contract employees work in the 42,000 acres that the Guard manages as a Maneuver Training Center. It includes several specialized firing ranges and a 16-building mock city used to practice urban warfare. The Defense Department retains ownership of the center, as well as 90 acres used by the U.S. Army Reserve.

Whether a facility's economic impact changes after realignment depends on the facility. Soldiers from various branches of the armed forces, along with law-enforcement professionals and foreign troops, still come to Fort Pickett to sharpen their skills. But while more people cycle in and out of Pickett, they stay for shorter training periods due to long-term changes in how the military operates and short-term adjustments in response to the war on terrorism. This translates into less spending off base.

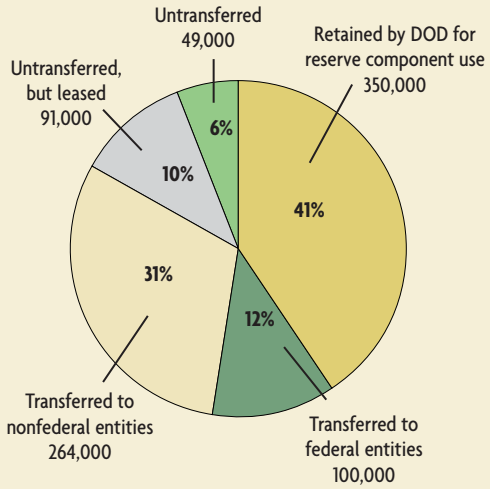
Fort Pickett itself still spends money locally, from rock used to cover 210 miles of trails to contractors who maintain and build new training areas. Officials estimate that the base spent between $1.5 million and $2.5 million in 2004.

In the Fifth District, there are other examples of base realignments. A naval technical center in St. Inigoes, Md., now operates as an annex to NAS Patuxent River located 13 miles away. There also are examples of federal reuse of military installations. A massive campus for the Food and Drug Administration is being developed in Silver Spring, Md., at a former naval warfare center. The Federal Aviation Administration operates a regional air traffic control center in part of Vint Hill Farms, a former communication station in Fauquier County, Va.

At Fort Pickett, Virginia Tech received 1,184 acres that had been transferred from the military to the U.S. Department

Land Grab

Uncle Sam has snatched up more than half of the 854,000 acres of military installations declared unneeded after four rounds of base closures and realignments. The Department of Defense expects the untransferred property will eventually go to nonfederal users, including local redevelopment authorities and private developers.



SOURCE: U.S. Government Accountability Office

of Education. The university used the property to create a centralized campus for its Southern Piedmont Agricultural Research and Extension Center. Other public facilities at Pickett include a satellite campus for Southside Virginia Community College and a driver training facility for state police.

While there has been extensive public reuse of bases, private uses are equally important. "It is with the value created by private development, along with subsidy sources, that you are able to add to the public benefits," says consultant Debbie Kern. "You have a new tax base."

When Uncle Sam Doesn't Want You

Yet the hardest part of the redevelopment process can be attracting private investment in a former military installation. Depending on whether the facility has something that the market wants, it can take awhile to replace lost military and civilian jobs.

Since 2000, Nottoway County has been turning its acreage at Pickett into an industrial complex called Pickett Park, but progress has been slow. Currently, the park's largest tenant is a lumber producer named ArborTech Forest Products. The company's $26 million, high-tech saw mill employs 65 people, 15 more than originally projected in 2000. Another company was supposed to invest $13 million and hire 100 people, but its principals couldn't obtain the financing they needed to get rolling. Several smaller firms have moved into buildings that the military had used, while the county operates a business incubator and rents out former barracks as single-occupancy housing.

Overall, only 155 of the 1,131 people working at Fort Pickett are at private firms in the county-controlled industrial park. If the Virginia Army National Guard didn't take over most of Pickett, a move that boosted the facility's military and civilian employment from around 750 in August 1995 to well over 900 today, there likely would have been a net employment loss after BRAC. Given the availability of industrial space in Southside Virginia, including a site in Nottoway County just a few miles from Fort Pickett, it probably wouldn't have been worthwhile for a developer to clean up the active part of the installation. About 15,000 acres is an impact zone heavily contaminated with shells and other debris from weapons fire.

"Why would a developer want to pay for a military base that comes encumbered with ancient utilities and facilities and its own environmental problems such as lead-based paint and asbestos ... when right next door might be a clean piece of property ... that they can get at the same price, or maybe cheaper?" asks Ken Matwiczak, a public affairs professor at the University of Texas at Austin. He is currently working on a report for the Congressional Research Service on the economic aftermath of BRAC rounds in rural communities. Fort Pickett is one of 16 installations his graduate students visited.

The key to a successful redevelopment is finding something about a base that uniquely addresses an existing need in the marketplace. Vint Hill Farms and Cameron Station were turned into mixed-use developments to take advantage of the demand for housing in Northern Virginia, while part of Myrtle Beach Air Force Base became an airport that supports coastal South Carolina's burgeoning tourism trade.

As many as 88,000 troops train at Fort Pickett annually, though they stay for shorter periods than before the 1995 BRAC changes.

One unique asset Pickett Park has is trees — average annual sales of timber in Nottoway County were $7.2 million from 1986 to 2001, ranking the county fourth in the state. It is this ample supply of timber that probably attracted ArborTech and Trout River Lumber, which occupied a hangar at Pickett Park until it built a new facility in Crewe. Also, a World War II-era officers club has been beautifully restored into an event and meeting space. The club has attracted a lot of business because it is one of the few facilities of its kind available in Nottoway.

It is much harder for a redeveloped military installation to support new industry, especially in remote rural areas with limited economic activity to leverage. "[Large corporations] don't have a reason to come to rural areas," says Matwiczak. "... There isn't transportation infrastructure [or] opportunities to interact with other industries."

Military base closures hurt. Whether communities can recover from the loss ultimately depends on how they utilize market forces. "You have some tools that can somewhat offset it," notes Kern, "but base development has to be primarily market-driven." **RF**

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A MENU OF OPTIONS

A Richmond Fed economist says that giving financial institutions limited choice about how they are regulated may produce a more stable and efficient banking system BY ANDREW FOERSTER

Let's say a stranger comes to you and wants to borrow a significant amount of money. If you're reasonable, you'll sit back and assess the interest rate that you may charge, the time you'll let the loan go before repayment, and then you'll think about the chance that the stranger won't repay the loan. You may be extremely careful in determining whether the risk of not being repaid is worth the benefit of some additional interest in the future. Now imagine that the money you are considering lending is money that you yourself have borrowed from a second stranger. How will your decision be affected?

You may be a little less concerned if you are loaning out someone else's money. If your loan is repaid, then you keep the interest and pay back your own creditor. If the loan fails, you go tell your creditor you've lost the money. You keep the money if you win, and leave someone else with the bill if you lose. This situation is an example of what economists call moral hazard: You have incentives to take risks because you can pass the bill if things don't go your way.

Borrowing from and lending to strangers is what banks do every day. Depositors lend banks their money by placing it in savings and checking accounts, and banks put all of their deposits together and then make loans to individuals or businesses that are looking for extra cash. And since bank deposits are generally guaranteed up to $100,000 by the Federal Deposit Insurance Corporation (FDIC) — meaning that depositors don't think about bank risk because they'll get their money back — banks can have an incentive to favor high-risk, high-reward loans.

One of the roles of the Federal Reserve System is to regulate banks and ensure they are behaving in a manner that is not too risky. The Fed shares this duty with several other institutions at both the federal and state level. These regulators have a responsibility to the public of preventing banks from making overly risky loans because of moral hazard, protecting the money of depositors, and encouraging banks to only make loans for projects that have a high probability of success.

The cost to society of having risky banks fail because of bad loans is potentially very high. During the 1980s, for example, savings and loan banks, burdened with loan portfolios ruined by high inflation, turned to making excessively risky loans, attempting to recover. Many of these risky loans backfired, and the result was a massive number of failures and large government bailouts.

In a perfect world, regulators would be able to easily monitor banks' loan portfolios, somehow understanding the risk of each and every loan and therefore the risk of the entire portfolio. Reality, however, is more complicated. Occasionally, a bank may have some unexpected shock to its portfolio — such as a sudden change in the risk of a loan — and the bank knows about the shock but the regulator does not. This discrepancy in information between regulators and banks is an example of what economists call hidden information.

For an external inspector like the Fed, monitoring hidden information and managing moral hazard is of central importance. Research by economists at Federal

PHOTOGRAPHY: GETTY IMAGES

Reserve banks and universities looking at various ways regulators can handle hidden information and try to control moral hazard has led to consensus on broad issues, but occasional disagreement over details. Ned Prescott, an economist at the Richmond Fed, has two proposals to manage these two problems. First, he advocates giving banks limited choices as to how they are regulated, with the idea they will self-select options that help regulators monitor hidden information. Second, he argues for close examination of high returns as a way of managing moral hazard.

A Wide Degree of Uncertainty

The economics literature differs in the details regarding prescriptions for regulating banks. In practice, regulation relies heavily on capital requirements, which limit the amount of leverage, or deposit financing, a bank can engage in.

So what is the optimal capital structure for banks? Economists do not agree on any one theory of capital structure for general firms. When considering a specific industry such as banking, the disagreement grows. With regard to general firms, a celebrated paper by Nobel Laureates Franco Modigliani and Merton Miller from the 1950s, "The Cost of Capital, Corporation Finance, and the Theory of Investment," argued that in a perfect economy, a firm's capital structure did not matter. They found that investments funded by borrowing or equity were equivalent because firm value depended only on the future stream of income from the investment, not on how the firm financed the investment.

In showing what did not matter, Modigliani and Miller helped point financial economists toward what did matter — departures from the model's perfect economy. A variety of departures such as taxes, bankruptcy costs, and agency costs have been developed.

One specific departure from Modigliani and Miller, and one considered highly relevant for bank regulation, is the work of Michael Jensen and William Meckling, who use contract theory to discuss firm behavior. In their 1976 paper "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," they identified the equity owners as the decisionmakers of firms. The managers of banks would, they concluded, act in the best interests of the equity owners of the firm and not necessarily the debt holders. Specifically, the equity holders only care about the positive side of the risk — they hope to make a profit on their investment and do not care if the bank loses the debt holders' money.

Equity holders, though, do care about losing their own money, so the way to control risk-taking incentives is to keep debt financing down. This is the logic behind capital requirements. Banks are highly leveraged firms — a large part of their funding comes from deposits, which are essentially a form of debt financing. The greater a bank's capital — its equity as a fraction of assets — the more equity holders have to lose.

In recent decades, globalization has put banks from different countries in competition with one another, so the financial community must strive for not only ideal capital regulation in the United States, but also ideal capital regulation in the entire world.

With this push toward global banking competition in mind, the United States entered into the international Basel Accord in 1988, which set general standards for capital regulation of banks in all agreeing countries. The standards set by Basel I, however, were fairly primitive, as capital requirements only depended on the types of assets a bank held. Each bank, with little regard to its loan portfolio's risk, had a set percentage of its assets that it had to hold as equity. The assessed risk on each loan in a bank's portfolio depended on broadly based categories — such as commercial versus government loans — that generally told little about the risk of each loan.

The deficiencies of the Basel Accord led to a follow-up agreement, Basel II, which is currently under consideration in the United States. Basel II is designed to change capital regulation mainly for large, internationally active banks. The new standards focus on three broad pillars: identifying and controlling risk, supervisory review, and market supervision. More sophisticated than that of Basel I, the capital regulation of Basel II relies heavily on a bank's self-assessment. Using their internal models of risk, each bank will report to the regulator their estimates of several figures, including risk and losses given default, for each loan. This assessment then determines the capital requirements that the bank has to meet given its overall risk.

The issue of regulation therefore returns to one of hidden information between the regulator and the bank. Even if the regulator has some information, the bank will always have more. What then has Basel II solved? In order for the system to work as planned, incentives must be provided to make banks report risk accurately. Clearly, nobody understands a bank's risk better than the bank, so self-assessment will be better than anything an outsider could produce.

New Proposals from a Fed Economist

Ned Prescott, an economist in the field of banking regulation theory at the Richmond Fed, advocates several novel approaches to regulating banks under Basel II. After doing his dissertation at the University of Chicago on contract theory and sharecroppers in less developed countries, Prescott looked for other ways to use the widely applicable tools of contract theory.

He turned to researching bank regulation, a change that came naturally, he notes, because "contract theory models were well designed to address bank regulation issues." Specifically, contract theory, originally developed to handle insurance problems created by moral hazard and hidden information, could look at deposit insurance in the banking industry. "A lot of bank regulation deals with perverse incentives caused by deposit insurance, so contract theory is a natural fit for study-

ing bank regulation," Prescott says.

Prescott's research agenda fits nicely with critical elements of Basel II. He sees the new accord as a step forward in bank regulation, but only if implemented properly. To be successful, it must address banks' incentives to conceal private information about risk. "What incentive does a bank have to report the true risks of its assets?" he asks. "Without adequate supervision and appropriate penalties, the answer is, 'Not much.'"

With this need for supervision in mind, Prescott focuses his research on ways bank regulators can manage the problems of moral hazard and hidden information. Traditionally, regulators use inspections and sanctions to ensure that banks meet capital requirements. Using these traditional tools in flexible ways, Prescott finds, can lead to a more efficient bank regulation structure and better results from the banking sector.

But how does the regulator achieve this efficient structure and ensure that banks follow the rules when it cannot perfectly monitor banks? In other words, since regulators have limited resources, what is the best way to allocate those resources in regulating banks? Prescott's theories challenge the traditional way that banking regulation is performed. He feels that his proposals to discourage banks' risk-taking are cost efficient and will not inhibit the actions of safe banks.

Prescott thinks one way to regulate banks easily is by giving banks choices from a menu of capital requirements and inspection intensity. Banks that look similar from the outside might face a trade-off along the following lines: the higher the capital requirement, the less intense the inspection. The striking result, Prescott says, is that regulators will end up inspecting the relatively safe banks that have lower capital requirements.

Isn't this counterintuitive? Shouldn't regulators inspect risky banks, not safe ones? Not exactly, says Prescott, noting, "The reason for this seemingly counterintuitive result is that inspections *prevent* risky banks from declaring that they are safe banks." Banks wish to avoid penalties, which they incur if inspections find that they did not hold enough capital for their risks. Banks that do not want to be penalized during inspections will accept tougher capital regulations; banks that wish to have eased capital restriction accept the possibility of getting an inspection.

> The striking result is that regulators will inspect the relatively safe banks with lower capital requirements.

The reason the regulator doesn't inspect risky banks is that those banks have admitted to being risky by accepting higher capital requirements. "[With proper penalties] no one wants to claim to be riskier than they actually are, [so] inspecting a bank that claims it is the highest risk is unnecessary," Prescott asserts. "This bank has agreed to hold more capital, and that is all the regulators desire." In the end, banks are not hiding any information, as they self-report the right amount of capital they should hold.

The advantage of this capital requirement and inspecting structure is that banks choose their own capital level from several options in a way that reveals their true risk level. Prescott's ideas for a menu of contracts extend from the original "precommitment approach," advocated by Paul Kupiec and James O'Brien of the Fed's Board of Governors. Under the precommitment approach, banks would set their own capital requirements, much like under Basel II, and then incur fines if they ended up not holding enough to cover any losses they received. This basic self-selection extends to a menu of contracts by offering specific options rather than letting banks set arbitrary capital levels.

Free to Choose

This idea of using a menu of contracts is not relevant only to banking regulation — insurance companies use it all the time. For example, most auto insurers let you choose your coverage from several packages. You assess your risk, and choose a package with deductibles, coverage, and payments that fit your risk most appropriately. Since the situation is similar in banking, it makes sense for the regulators of banks to give similar options to the banks under their supervision.

Prescott's personal experience contains another example of a menu of contracts in regulatory environments. He recalls a trip to Mexico, where each individual going through customs had to choose a line: green or red. People in the green line had a low probability of being searched, but violations carried hefty fines. Those in the red line were automatically searched, but lower fines accompanied violations. Since officials clearly stated the nature of each line, travelers could choose the option that fit them best. In a similar manner, Prescott believes, banks should be able to choose from a menu the option that fits best.

Despite the political or legal barriers, Prescott points to practices that mimic the menu of contracts approach. "Some practices use menus of contracts implicitly," he says. For example, the internal models approach to banking regulation — presently used for a portion of a bank's portfolio — requires banks to estimate their own value-at-risk, which is a statistic estimating potential losses. Based upon this statistic, banks must set a certain level of capital. Since their internal models determine their capital requirement, banks can alter those internal models to yield preferred results. Specifically, a bank can make its estimates risky or safe in order to influence the exact amount of its capital requirement. But the bank is penalized if losses on the portfolio exceed the capital they hold.

Prescott also studies the presence of moral hazard, which encourages banks to make risky loans, particularly when

they are poorly capitalized or in bad economic condition. Over time, banks that submit to this temptation will typically have more variation in their returns than those banks that have relatively safe and steady loan portfolios. Risky banks understand that some of their loans have a significant chance of failing, but hope to reap significant gains from those which are repaid.

The savings and loan banks of the 1980s provide a good example as to what happens when banks gamble. The inflation of the early 1980s significantly decreased the values of loan portfolios of many of these savings and loan banks, putting them on the path to financial ruin. In an attempt to break even, these banks made more and more risky loans, hoping that having a few succeed would bring in enough profit to keep the bank alive. If these risky loans did not pay off, the bank would still be insolvent, or no worse off than before making the loans.

This strategy of "gambling for resurrection" stands in contrast to sound banks, which did not need to make the extremely risky loans to stay afloat. These safer banks could continue making lower-risk, "safe and prudent" loans because they did not face a financial crisis.

Banks that make unusually high returns, therefore, may be in financial trouble and gambling for resurrection. The risky gambling may pay off and produce high returns, but sends a clear signal that a bank is excessively risky. One way to discourage this risk, Prescott argues, is to use regulatory contracts that include fines when banks generate extremely high returns, because it discourages high risk-taking strategies.

In "Bank Capital Regulation with and without State-Contingent Penalties," with co-author David Marshall of the Chicago Fed, Prescott admits, "the particular form taken by the optimal fine schedule is somewhat unusual." In a subsequent paper "State-Contingent Bank Regulation with Unobserved Actions and Unobserved Characteristics," the same authors admit that the contracts that they advocate "often require fines on high returns, an approach that could encounter political and even legal obstacles."

Others have raised concerns as well. John Boyd of the University of Minnesota, in published comments on Prescott and Marshall's work, worries about the proposed fines' effects on innovation. He notes, "It would be extremely difficult for regulators to distinguish between large profits due to risk-seeking and those due to financial innovation." Pointing to several risky innovations in the 1990s that turned out to be successful, he worries, "there would be social costs to any tax scheme which penalized such marvelous innovations."

Responding to the criticisms that their proposed fine system would face implementation barriers and stymie innovation, Prescott and Marshall suggest using inspections rather than fines. That is, instead of fining banks that produce extra-high returns, regulators could trigger inspections to determine if the returns resulted from financial innovation or inappropriate risk. In this way, the high returns act as a sort of "red flag" signal to regulators.

These banking regulation proposals would help reduce the risk that banks take, a good result for society. Risky banks that fail can lead to large payments from the FDIC to depositors, which costs the government money. In addition, risky banks make loans to businesses or individuals that are not deserving of the loan because of low probability of repayment. In other words, risky banks help fund inefficient projects. The loans made to the undeserving groups could be made to companies or people with better plans for using the funds.

Prescott hopes to expand his research in the future to consider the third pillar of Basel II, which focuses on market supervision. He is looking into how regulators can use market data to help create better regulatory environments, allowing banks to do business while encouraging safe practices. **RF**

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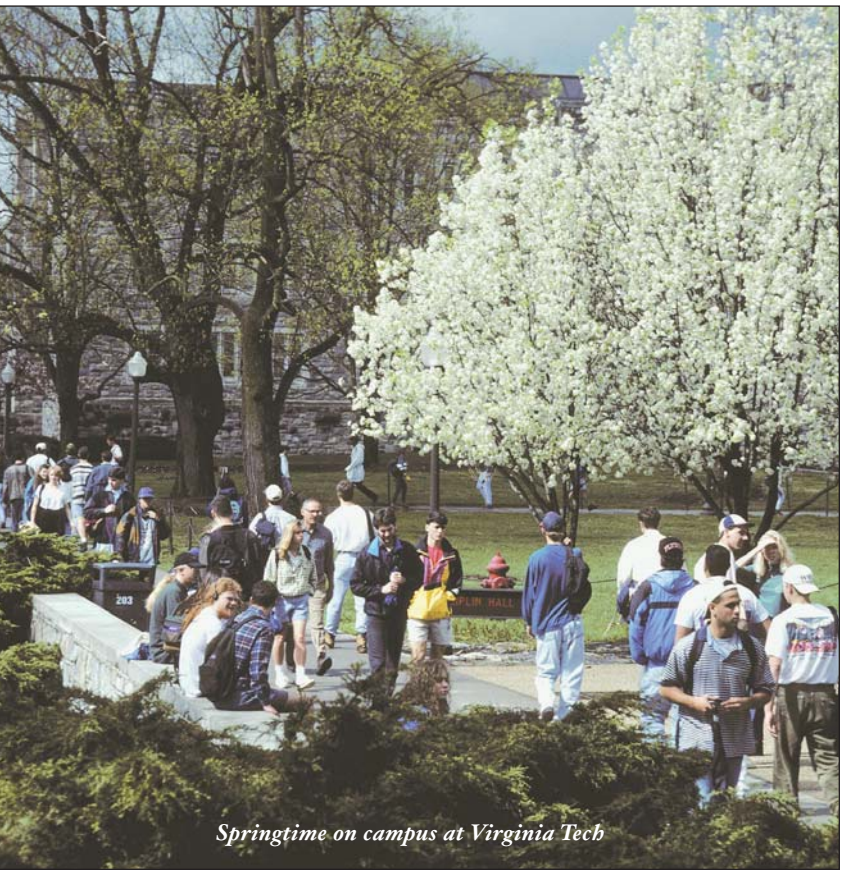
YOUTH MOVEMENT

Blacksburg, Va., and Morgantown, W.Va., are counting on their local universities to create good-paying jobs that will keep kids from leaving town after graduation. But is that realistic? BY DOUG CAMPBELL

You could do worse, much worse, than Blacksburg in the spring. This time of year the rolling landscape in southwest Virginia is popping with purple and green, the mountain air crisp. The campus of Virginia Polytechnic Institute and State University, more famously known as Virginia Tech, bustles with backpack-bearing students and brisk-walking faculty. Throughout town the streets appear to be recently paved and they are clean.



Springtime on campus at Virginia Tech

PHOTOGRAPHY: BOB VELTRI/VIRGINIA TECH

What a great place to live. If only there were more good jobs.

That's where Joe Meredith comes in. He is president of the Virginia Tech Corporate Research Center, which 10 years ago was hardly worth mentioning but today is home to 1,830 high-tech, mostly private-sector workers. The CRC was established in 1985 as a for-profit subsidiary of the Virginia Tech Foundation; its mission is to at once advance technology-transfer operations at Virginia Tech as well as to spur the economy of southwest Virginia. Today it makes its own money and does not draw on university funds.

On a recent afternoon, Meredith was chatting with a visitor over grilled chicken sandwiches at the research center's on-site café when a park tenant wanders over. Meredith looks up and says, "I got a resume this morning from a guy whose wife has been accepted to the vet school. He's a marketing guy." The tenant is chemistry professor and entrepreneur Ketan Trivedi. His face brightens with this news: "We need him," Trivedi says emphatically. "Send him to us please. Right away." Meredith nods and smiles.

Welcome to 21st century economic development, college-town style. Meredith is a significant piece of Virginia Tech's growing impact on greater Blacksburg. More to the point, he is part of a wider effort by community and university leaders to harness the considerable economic power of their local schools of higher education. Universities like Virginia Tech are being counted on to create more jobs in more places than ever before.

In places like Blacksburg and Morgantown, W.Va., there are jobs, sure. But most of the really good ones are already under the auspices of the universities that call those cities home, and there are only so many of them. This situation tends to be most pronounced in otherwise rural towns that are home to land-grant and state universities; you don't see nearly as much hand-wringing over retaining and recruiting young and educated professionals in places like

Cambridge, Mass., Austin, Texas, and the San Francisco Bay area. What nonurban economic developers want is their regions' universities to create more private-sector, for-profit, off-campus jobs.

This is a relatively new concept: In the past, economic developers in rural areas were just thrilled to have all those college employees and students spend their paychecks and allowances with local merchants. Now the thinking has changed. Classrooms are great for educating young people. But only a critical mass of good jobs, it is believed, will keep university grads from fleeing the region after graduation. Equally, only large numbers of good jobs can attract accomplished out-of-towners.

Research parks have become the leading solution to this problem. Historically, research parks are also a relatively new concept. The majority of the 150 university research parks now operating in the nation were established after 1980. The long-term vision is that these endeavors will spawn scores of knowledge-based jobs that spread farther from campus — to neighboring communities whose economic profiles pale in comparison to generally prosperous college towns.

But it's not yet apparent that this vision is realistic. Yes, the research park at Virginia Tech is such a smash that it is drawing visitors from universities around the globe. Encouraged by places like Virginia Tech, Morgantown's West Virginia University recently broke ground on its first research park, anticipating that it will employ 2,500 workers by 2015. (That would be almost 5 percent of the Morgantown MSA's current workforce.)

At the same time, university officials and local economic developers acknowledge that spreading the wealth beyond a core area around their schools is a challenge. As much as the communities surrounding college towns would like to reap more benefits from the schools, the possibilities have limits. Besides the lure of good jobs elsewhere, rural college towns are also battling the basic human desire to seek out new places to live and work.

"Clearly, these other communities would like to have more of Virginia Tech. They see it as an engine. But we struggle to see how to do that," says Ted Settle, director of the Office of Economic Development at Virginia Tech. "We haven't, I think, figured out how to help those communities."

New Twist on Town and Gown

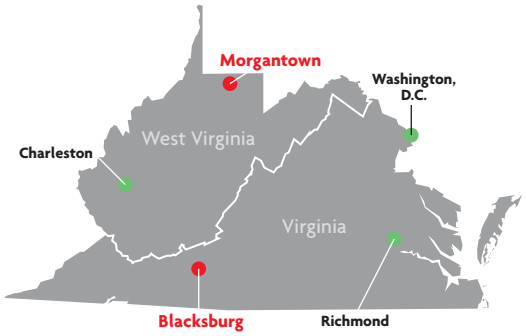
The economic impact of universities is well known and documented. In a 2001 report, the National Association of State Universities and Land-Grant Colleges found that member institutions provide an average 6,562 jobs, not including part-time student employees. Additionally, for every university job, another 1.6 jobs are generated beyond campus, the survey said. Most of this impact is in the way universities have always helped their local economy – with students paying tuition and faculty and staff spending their money locally.

Virginia Tech was found to employ 8,038 people and generated an additional 6,806 positions in the surrounding area. Its presence was said to increase Montgomery County's gross regional product by $521 million, or $16,000 per household. A more recent but different study put economic impact by West Virginia University on the entire state of West Virginia at $2 billion a year. West Virginia University directly provides almost one out of every three jobs in the entire Morgantown MSA.

Increasingly, the quest for economic development officials in college towns is to unlock even more value from their resident universities. They want to keep those engineering degrees from leaving. And they also want to recruit human capital from other places.

So how well is greater Blacksburg doing in holding onto and growing its youthful and educated population? "Not very," says David Rundgren, executive director of the New River Valley Planning District Commission, which encompasses five counties including the one that is home to Virginia Tech. "There's a tremendous amount of talent out of these [thousands of] students from which to develop corporations ... The goal of education is to train you so that you can work for somebody. The problem [in the New River Valley] is that we don't have anybody to work for."

Rundgren is exaggerating for effect. The employment situation in Blacksburg is relatively healthy, not dissimilar to any number of college towns — where thousands of people work for the university as well-paid administrators or faculty and where thousands of students come from out of town, spend their money and tuition and indirectly fund service-sector jobs. The number of jobs the university proper creates is a simple function of enrollment and research funding. The problem, or at least the perception of the problem, is that the farther you get away from Virginia Tech, even well within commuting distance, the farther employment rates fall and the number of "good" job opportunities diminish. (To be sure, the New River Valley's economic profile isn't miserable, but Rundgren sees plenty of room for improvement.) Policymakers are



The cities of Blacksburg, Va., and Morgantown, W.Va., are economically vibrant, thanks in large part to the presence of Virginia Tech and West Virginia University, respectively. But in these otherwise rural, somewhat isolated communities, the economic benefits of playing home to a university are limited. Neighboring towns, even those well within commuting distance, pale in economic performance by comparison.

vexed as they watch what they term "brain drain": The university isn't producing a critical mass of students who stay in the region after graduation. Nor is it creating enough jobs to lure droves of out-of-towners.

Blacksburg is economically healthy, thanks mostly to the presence of Virginia Tech. The New River Valley, which encompasses Blacksburg, isn't faring as well, however, with unemployment at 4 percent, above the state average. Personal income growth in the metropolitan area that encircles Blacksburg lags the U.S. average. A 2004 report by the New River Valley Planning District Commission described the "distressed economy of our region." With an eye toward recently shuttered manufacturing plants throughout the area, planners said that old-economy industries "can no longer provide the number of jobs and spin-off companies it did so well in the past. We must build on our local talents and strengths."

A recent study by Virginia Tech's Center for Regional Studies found a dearth of knowledge-based jobs in the region and mean earnings that were "extremely low" compared with six similar areas around the country (The six compared areas were Colorado Springs, Colo.; Fort Collins, Colo.; Athens, Ga.; Asheville, N.C.; Knoxville, Tenn.; and Lexington, Ky., all university towns in otherwise rural regions.)

A recent survey asked students in the New River Valley whether they were thinking about staying in the area after graduation. The report is not yet released, but Rundgren says the overwhelming majority of responses were negative. But when asked whether they would stay if there was a good job waiting for them, 98 percent switched their answer to the affirmative. Rundgren certainly doesn't expect that many young people to ever decide to stay in the area, but he takes the results to mean that the New River Valley would do a much better job of keeping its kids if it had more good jobs. Rundgren is working on several programs to create these jobs, but the biggest promise in the New River Valley remains Virginia Tech and the Corporate Research Center. "When we say Virginia Tech, that's huge," Rundgren says. "It makes a tremendous difference in all kinds of activity."

Turnaround

It can be slow-going starting a research park. The early years of the CRC were not promising. Five years after opening in 1988, thanks to a $4 million contribution from the Virginia Tech Foundation with 10 tenants and a single building, there were just 20 tenants, half of which were university offices. Joe Meredith arrived in 1993 and developed a value proposition that focused on helping young firms grow — instead of serving as a mere property manager — and that made the difference. Today there are 125 tenants representing businesses that usually align with Virginia Tech's core competencies in engineering and physical sciences. Most of the employees are not university employees, meaning these are new jobs that arguably wouldn't have existed without CRC. Tenants get proximity to Virginia Tech and its research capabilities and easy access to a crop of young, affordable employees.

Almost counterintuitively, the CRC until just this spring wasn't anything like a business incubator, in the sense that it didn't seek out start-up companies with no funding and no revenues. Only in April did a true incubator, called VT Knowledge Works, open in a new building (the 18th at the park) and start helping 13 incoming startups grow their operations and align them with investors and advisers. Meanwhile, Meredith is plenty busy. He keeps clipboards on his desk with all his active prospects. There were 20 of them in April, all real firms with revenue and a strong interest in locating in Blacksburg.

Several communities have approached Meredith with a proposition: Build a CRC in my town. Meredith isn't so sure that's feasible. "Part of it is location specific, meaning we're adjacent to Virginia Tech," he says. "It's a chicken-and-egg problem. What comes first, the entrepreneurs and the technologies or the [research park] services. If you had services, would it attract entrepreneurs and technologies? I don't know."

Morgantown Takes Notice

By no means is Virginia Tech's research park an economic panacea. But its success is the sort that has emboldened other universities to start their own research parks. One of the most recent to get going is West Virginia University.

Like Blacksburg, Morgantown looks like an oasis of economic vibrancy when viewed on paper. There is also a growing biometrics corridor down Interstate 79 toward Clarksburg, where the FBI's fingerprint center has helped spawn a cluster of like-minded firms. As the state's leading university, however, the responsibility for driving the new economy is keener here than at Virginia Tech. West Virginia ranks 48th out of the 51 states and the District of Columbia in net migration of the "young, single, and college educated."

Between 1995 and 2000, according to the U.S. Census, West Virginia lost 4,691 of this group (aged 25 to 39, with at least a bachelor's degree), a rate topped only by the Dakotas and Iowa. By contrast, Virginia landed relatively high on the list, gaining 6,475 of that cohort during the same period. But data from the Census Bureau suggest that the lion's share of those young and educated folks migrated to Washington, D.C.'s Northern Virginia suburbs — not to the southwestern part of the state.

Russ Lorince, director of economic development at West Virginia University, says the under-construction research park will be the highest-profile component of the school's effort to reverse the trend of poor economic showings. He says it's a natural move for the university, since more compa-

nies are giving up costly R&D and looking to schools to pick up the slack. "It's a tragedy to see people from your region grow up and graduate from the local university and then go to Seattle and Austin and San Diego, some to return and many not to return," Lorince says. "So our desire is to create opportunities for our young people and at the same time we create this stream of talent of young employees for potential employers."

The West Virginia research park is expected to open around winter 2006 at an initial investment of $19 million, paid for from grants and state and federal agencies. Lorince expects most tenants will have ties to the university and its research strengths — biometrics and forensics, advanced materials and information technology.

Tom Witt, director of the Bureau of Business and Economic Research at WVU, says that land-grant universities are taking the next logical step from their origins. Where their outreach once concentrated on aid and advice to farmers and establishing branch campuses and classrooms, now the mission is job creation. "There's an increasing sense of entrepreneurial activity focused on economic development," Witt says. "With the adverse demographics that we face in this part of southern Appalachia, the development of these types of institutions is one way of readdressing the loss of young people." They seek, Witt says, "a reverse brain drain."

A Realistic Vision?

Expecting research parks to fix many economic woes might still strike some as naïve. But there are ardent believers. Here's what William Drohan, executive director of the Association of University Research Parks, tells to skeptics: A West Coast university 50 years ago fretted over losing a stream of talented graduates each year to jobs in New York and Chicago. So the school, Stanford University, opened its own research park. Drohan says that Silicon Valley would not exist today were it not for Stanford University Research Park, whose famed original tenants included Hewlett-Packard. And closer to home there is Research Triangle Park, which Drohan says "to call a pipedream was an understatement."

Now, a fair amount of luck is involved with those success stories, Drohan allows, but that doesn't mean some similar sort of brushfire of innovation can spread across West Virginia or southwest Virginia. "When you start this momentum and create these new jobs that feed off each other, it can be just like what happened in Silicon Valley."

The United States may never birth another Silicon Valley, but Lee Cobb would settle for just a sliver of that kind of success. Cobb is executive director of Region 2000 Economic Development Council, which covers greater Lynchburg in south-central Virginia. For the past year, Cobb has been in talks with Virginia Tech officials about setting up a tech-transfer office in Lynchburg, which is about 90 miles from Blacksburg, home to several liberal arts colleges and saddled with a reputation of being a poor choice of location for young folks just starting out.

Cobb's group aims to get approval this summer and funding from the state soon after. Without a solid link to a research university, Lynchburg is at a disadvantage in the 21st century economy, Cobb says. He grants that it's only human nature to want to explore other lands, but he thinks

A recent West Virginia University graduate celebrates a successful college career. Here she poses with the Mountaineer statue, one of the official emblems of the university.

Virginia Tech is Lynchburg's greatest hope for appealing to a wider swath of workers. "To me, it's just reality that kids grow up somewhere, they want to go somewhere different. That's a challenge for us and it's an opportunity for us since we have probably close to 10,000 students in our region," Cobb says. "We've got to make those kids understand what the opportunities are here. And that's one of the things that this alignment with the university in the city would help with." **RF**

PHOTOGRAPHY: DAN FRIEND/WVU PHOTOGRAPHIC SERVICES

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From the Classroom to the WORKPLACE

So, where are the jobs?

BY JULIA R. TAYLOR

It's that time again. College students are graduating and looking for jobs. On the bright side, more than 3.1 million jobs have been created since June 2003, an encouraging trend for job seekers. And the demand for skilled employees continues to rise, making this the best hiring period for college graduates since the 2001 recession. Still, landing that first position is often challenging. Many grads are finding that education isn't enough — employers want experience, the type often gained during internships.

According to the Department of Labor, as of May, the national unemployment rate stands at 5.1 percent, down considerably since the peak of the most recent recession. But these numbers vary from state to state. Here in the Fifth District, for instance, Virginia enjoys a relatively low unemployment rate of 3.6 percent, while South Carolina's stands at 6.3 percent, according to numbers released in May 2005. Not all jobs are created equal, of course, and if graduates want to maximize their potential, they need to consider where the jobs are, in terms of both location and industry.

Not surprisingly, some industries are simply "hotter" than others. Nationally, demand is high for teachers and people with health-care and high-tech training. Also, the increased emphasis on national security has spawned many new government positions, a large share of which are in or near Washington, D.C.

Ray Owens, who directs the Richmond Fed's regional economics program, says that the Fifth District is in a good position for job growth because of relatively concentrated employment in the region's metropolitan areas — that is, because of "agglomeration." Simply put, there are benefits to a large number of firms locating near each other, benefits that can lead to even greater population and job growth. The Fifth District has several cities that illustrate this concept — for instance, Charlotte, Raleigh-Durham, and Richmond, the last of which recently joined the ranks of the nation's 50 largest metropolitans areas. But no metro area in the Fifth District seems better positioned for job growth than the Washington-Baltimore corridor, with its large and growing number of service-sector jobs.

Many students are keenly aware that some degrees are more marketable than others. One sophomore from the University of Richmond describes her decision the following way: "I need to figure out my major soon, and I don't know whether to major in something I like or something that will get me a job."

But as Andy Ferguson of the University of Richmond's Career Center is quick to stress, a strong liberal arts education, thought by many as not particularly practical, can provide many valuable job skills. "When you start looking down the road, the major doesn't matter anymore. Employers want someone who is bright and motivated." The student who successfully completes a degree in history or English will have learned analytical skills through paper writing and communication skills through giving presentations. As Ferguson explains, these are attractive qualities for any candidate for any job. "Students make the mistake of listening to the job market too much. If the only reason you get into finance is because that's where you think the jobs are, it is going to make you a less competitive candidate."

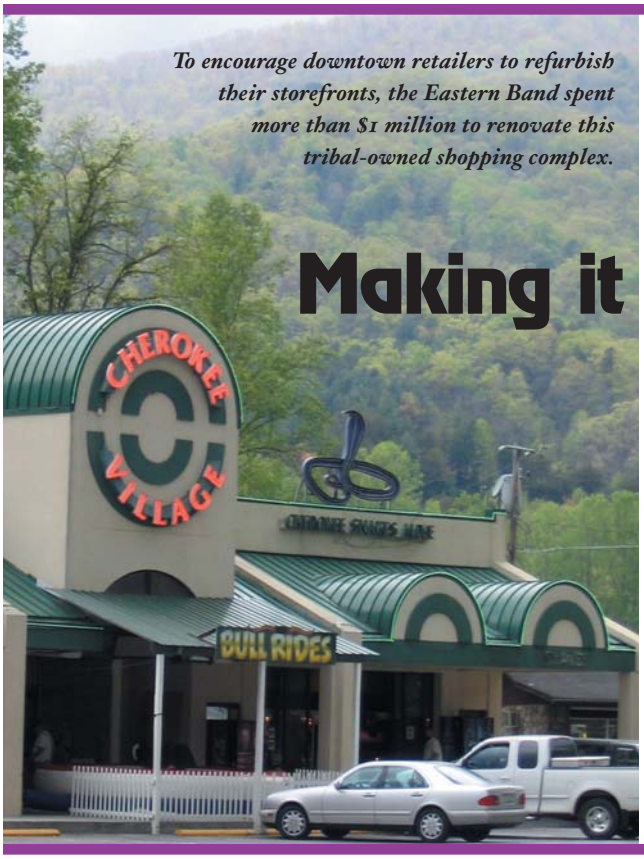
Still, it is hard not to be at least a little driven by where the jobs — and the money — are. CNN Money recently stated that the national average starting salary for a computer engineer is $51,496, about $20,000 more than someone with a liberal arts degree can expect to earn. Here in the Fifth District, the numbers are roughly comparable, but vary across the region, depending on the cost of living.

Although the job market for recent grads is better than it was five years ago, it still takes work, career counselors say. When times are tough, as during the 2001 recession, people tend to go back to school — for at least two reasons. First, they may simply need more education to gain an edge over fellow job seekers. Second, the "opportunity cost" of going back to school is lower, since they may be out of work already. The result: a larger number of skilled people in the market competing for prized jobs. And this means that students need to look for ways to set themselves apart — before they graduate.

Even employers offering "entry-level" positions prefer experience, such as time spent in college doing internships or volunteering. These endeavors speak to the ambition of a student. Students also need to develop skills that they can build upon and will carry over into future jobs.

Sue Story, the director of the career center at Virginia Commonwealth University in Richmond, explains. "What it boils down to is most employers want students with experience. Students are realizing this in college. They're getting internships and co-ops so they can get that first job." So while some students about to graduate have completed their internships and volunteer work, and have their prospective jobs in line, others are still sweating it out in the college career center. **RF**

PHOTOGRAPHY: S. WANKE/PHOTOLINK/GETTY IMAGES



To encourage downtown retailers to refurbish their storefronts, the Eastern Band spent more than $1 million to renovate this tribal-owned shopping complex.

Making it on the Reservation

The Eastern Band of the Cherokee Indians shares the economic problems that afflict tribes nationwide and the beleaguered rural communities of western North Carolina

BY CHARLES GERENA

Whether it's Kitty Hawk or Virginia Beach, every tourist destination has it — a strip of retailers whose purpose is to empty visitors' wallets. Downtown Cherokee in western North Carolina has one too. The major difference is the frequent appearance of buzzwords like "tepee" and "chief" above storefronts.

On an overcast morning in April, the tourist season is just warming up. A guy stands outside of one shop looking bored and rather chilly dressed in Indian garb, waiting to greet people and have his picture taken. For now, there are only a few couples and families wandering around, browsing traditional crafts sold alongside cowboy paraphernalia and merchandise emblazoned with "Great Smoky Mountains."

This is the economic heart of the Qualla Boundary, the largest reservation in the Fifth District and home of the Eastern Band of Cherokee Indians. Like its mountain neighbors seeking economic opportunities, the Eastern Band has embraced tourism. It is an industry where the tribe's culture and history provide a comparative advantage. A casino that opened in 1997, one of relatively few Indian-run gaming operations east of the Mississippi, has jump-started the tribal economy.

Across the country, the 511,000 American Indians living on reservations have struggled to succeed. Their per-capita income grew 83 percent from 1970 to 2000, outpacing the nationwide rate. Still, it remained about one-third of the U.S. average. Median incomes, poverty levels, and unemployment on reservations followed a similar pattern — they improved significantly over the last decade, yet still compare poorly to the country as a whole.

Economists and historians blame this lagging performance on problems with financial, human, and physical capital; reservations either don't have enough of it or use it inefficiently. Tribes have had to overcome a legacy of federal micromanagement of Indian affairs, along with the present-day problems faced by all rural communities. Furthermore, a complicated web of land-use and ownership policies on many reservations makes it hard to find investors for new ventures. The Eastern Band is trying to meet the unique challenges of life on the reservation and in western North Carolina with pragmatism and a determination to survive.

Reservation Life

Survival was everything when the federal government forced thousands of Cherokee Indians from their ancestral lands throughout the Southeast during the late 1830s. Many died during the grueling westward march known as the "Trail of Tears." About 1,000 stayed behind, some hiding in the mountains of North Carolina to evade the U.S. Army.

The story of the Eastern Band doesn't end there, asserts tribal member James Bradley. "People say, 'Oh they were removed, how sad,' and they don't get a sense of how we fought to stay where we were and the leadership we've had over the years," says Bradley, a program associate with the nonprofit Cherokee Preservation Foundation.

PHOTOGRAPHY: CHARLES GERENA

The Eastern Band has a long history of self-determination. After many years of legal wrangling, tribal members persuaded state officials to recognize their rights as permanent residents in 1866. This paved the way for the federal government to acknowledge their rights and for the tribe to reacquire some of its land. A general council was held two years later, a new chief was elected in 1870, and the tribe incorporated under state law in 1889.

Today, a democratically elected council serves as the legislative branch of the Eastern Band's tribal government. A principal chief and vice chief comprise the executive branch, while a tribal court serves as the judiciary. The government provides basic services like sewage treatment and police protection, as well as social services like daycare and senior housing, for the 8,500 tribal members who live in the Qualla Boundary. (About 5,000 live off the reservation.)

While the Eastern Band is a sovereign nation with its own laws, many of them are harmonized with state and federal regulations. For example, everyone who works and lives in the Qualla Boundary pays a tribal levy on purchases that is equal to the state sales tax. Also, while tribal members don't pay a highway-use tax on vehicle sales, they must have a valid driver's license from the state.

Tribal governments often perform many of the administrative functions of a county. But not every tribe has a long-standing, widely accepted system of self-governance like the Eastern Band. According to sociologist Stephen Cornell and other researchers with the Harvard Project on American Indian Economic Development, this is essential for economic success.

"Indian nations that have taken over decisionmaking power—and have backed that power up with capable governmental organizations and structure—have done much better than those who haven't," says Cornell, co-director of the Harvard Project. "You have to create institutions that the people being governed are likely to believe in and view as theirs."

Businesspeople dislike uncertainty, so they are less willing to invest somewhere that doesn't have a legitimate, stable government which consistently enforces the rules of the game. "You've got to create an environment [where] they feel comfortable and that looks promising," notes Cornell. It doesn't have to guarantee success, but "it has to be a place where people are going to get a fair shake."

The complicated nature of land ownership has stymied economic development efforts on reservations. Reservation land can be owned individually by tribal members or collectively by the tribe. In both cases, there can be restrictions on transferring or mortgaging property. Or the U.S. Secretary of the Interior can hold the title to reservation land in trust. The Eastern Band placed its lands under federal control in 1924, and other tribes did so at other times for the same reason: to keep non-Indian speculators from snatching up Indian territory for their gain.

The trust arrangement has worked all too well. It complicates any effort to obtain land or capital for new development. Individually owned land held in trust can be mortgaged only with the approval of the Interior Secretary. A non-Indian can't purchase the land unless it is subject to foreclosure or cannot be transferred within the tribe, plus any sale requires federal approval. Meanwhile, tribal land held in trust cannot be mortgaged or sold. While it is leasable for extended periods, the tribe and the Bureau of Indian Affairs have to give their OK.

Land issues were a headache for Carr Swicegood, an Asheville businessman who opened a large shopping center in the Qualla Boundary four years ago. Swicegood attracted tenants like Food Lion and Family Dollar to Cherokee Crossing, but banks were leery about financing the project and the development process took longer than usual because of the approvals he had to get for his 50-year ground lease. Meanwhile, his efforts to develop a large parcel across the road haven't been successful.

In general, researchers have found that productivity is significantly higher on reservations where a relatively large portion of the land is privately owned compared to those where land is held in trust or owned by the tribe. Part of the reason is that people may be reluctant to invest their knowledge and money into making their property more productive if they have a hard time reaping the added value in the future. "You've got to get the incentives right," says Leonard Carlson, an Emory University economist who has studied Indian reservations.

Indeed, many business owners in downtown Cherokee were letting their storefronts age, until the tribe recently renovated its strip center and began offering low-interest loans for external renovations. Now, new green roofs and stucco facades greet customers at several eateries and shops.

Rural Life

Location also works against reservations. The federal government often created them on the fringes of developed areas. Therefore, they share the economic challenges faced by isolated rural communities, challenges that limit business development to small firms and home-based service enterprises.

Remote rural areas tend to have higher transportation costs and limited comparative advantages for industry. Additionally, the mountainous terrain in the higher elevations of western North Carolina leaves little flat land for sprawling factories, subdivisions, or retail centers. This makes it hard to attract human and financial capital, which tend to migrate to where the best opportunities are. It also results in insufficient population density to attract and support large-scale service industry.

As a result, the seasonally adjusted unemployment rate of western North Carolina's rural counties reached 5.7 percent in April 2005 compared

to 5.5 percent for the whole region and 5.3 percent for the state. This gap has persisted for the last four years.

Meanwhile, unemployment in the Qualla Boundary is about 12 percent. As with many Indian reservations, the Boundary only supports a variety of small employers — mostly service firms and retailers — leaving the tribe as the single biggest employer. Most people work directly for the government or at tribal-owned enterprises, including two gaming operations, a group of service companies operated by the Cherokee Boys Club, and a bottled water producer.

Manufacturing activity in the Qualla Boundary has dwindled from several firms to just one: a company that mass-produces toys and souvenirs. Most employment opportunities are outside of the reservation, such as a Stanley Furniture plant to the west.

Shouldn't people move away to find better economic opportunities? Carlson argues that such migration can hinder efforts to preserve the unique heritage of Indian tribes. "If you want a culture or language to survive, you need to have a place where there is a concentration," he explains. Otherwise, it becomes integrated into the mainstream. That's why many tribal members have stayed on the Qualla Boundary or returned home to find ways to leverage native skills and the region's assets.

One asset that the Boundary has is natural resources. In the past, it supported agricultural activity, but timber supplies have been depleted and families have found better ways to make a living than by farming. Today, the Boundary's natural resources support a different industry: tourism and recreation.

In general, this sector can be a source of economic growth for rural areas, as dollars come from more urbanized areas to communities where traditional industries like agriculture and manufacturing have been declining in employment. Of course, not every Indian tribe wants its reservation turned into a tourist trap — the Havasupai Indians haven't built transportation infrastructure to bring people to their scenic tributary of the Colorado River. Nor does every tribe have a major metropolitan market within driving distance and something to offer for visitors.

For the Eastern Band, tourism has been a good fit. Western North Carolina is a few hours from Charlotte and Atlanta. The Blue Ridge Parkway and the Great Smoky Mountains National Park, both just north of the Qualla Boundary, draw outdoor lovers. And one hour across the border in Tennessee are two other tourist magnets: Gatlinburg and Pigeon Forge, home of Dollywood.

The result is the plethora of roadside shops that hawk "authentic" Indian knickknacks to people heading toward the national park, which opened in 1940. One shop started by Chief Saunooke in 1939, the year that the first segment of the Blue Ridge Parkway opened, has expanded several times. Tribal members have made money every summer by dressing up in Indian garb to perform for shoppers outside of stores, a practice known as "chiefing."

Today, tourism and recreation is the primary industry in the Qualla Boundary, accounting for 2,300 of the Boundary's 5,500 jobs in 2003. About 1,700 tourism positions are at Harrah's Cherokee Casino, a tribal enterprise with 80,000 square feet of video gaming devices and two 15-story towers of luxury accommodations. Other attractions include the "Unto These Hills" outdoor drama, a recreated Indian village, and two small amusement parks.

Lagging Incomes

The three western North Carolina counties closest to the Qualla Boundary share the reservation's lagging economic conditions. Still, county residents fare relatively better than the Eastern Band of Cherokee Indians.

State	Median Household Income ($)	Population Below Poverty Level (%)
Eastern Cherokee Reservation	27,350	23
Jackson County	32,552	15
Macon County	32,139	13
Swain County	28,608	18
North Carolina	39,184	12

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

Betting on Gaming and Tourism

Like every industry, tourism has its drawbacks. It pays relatively low wages — about $7 an hour, according to Sharon Blankenship of the Cherokee Native American Business Development Center. Then, there are concerns about preserving the tribe's culture and geographic beauty that many tourists pay to see.

The biggest downside is that tourism can be seasonal. Busloads of people fill the casino year-round, but the Indian village is open only from May to October and the outdoor drama only runs during the summer. As a result, the unemployment rate in the Qualla Boundary varies from a low of 6 percent in the summer to a high of 35 percent in the winter.

Still, tourism brings dollars into a community where there are few major sources of economic activity. The question is whether it makes a material difference in the lives of the Eastern Band of Cherokee Indians. The answer appears to be "yes," largely due to gaming. Similar economic improvement has occurred in other reservations with casinos.

Tribal members occupy a third of the casino's jobs, most of which are hourly positions that pay an average of just under $10 an hour. In addition, businesses on the reservation get about half of the $15 million that the casino

spends on goods and services in North Carolina and surrounding states.

In addition to the economic ripples created by what the casino spends, the tribal government has been able to do more. Half of the net revenue from the casino, as well as from a tribal-owned bingo parlor, goes directly into the government's coffers. Officials have used this money to expand health care and other services, which has required an expansion of its payroll to about 900 employees.

The other half of the tribe's net gaming revenue goes to each enrolled member as a biannual payment, which amounted to $5,200 in June 2005. These per-capita payments accumulate for underage members until they are 18 years old and have a high school diploma. At that point, the windfall can be used for educational purposes ... or for a post-graduation spending spree.

Millions of visitors pass through the Eastern Band of Cherokee's reservation on their way to the Great Smoky Mountains National Park.

The per-capita payments exceeded $50 million in each of the last three years, helping to boost incomes and reduce poverty levels in the Qualla Boundary. The economic effect of these additional dollars has been more regional than local, though. Without a critical mass of year-round customers, many local businesses cater to the tourist trade. As a result, residents go outside of the reservation for basic goods and services.

"You have to travel quite a distance to [shop]," says Michell Hicks, the tribe's principal chief. "A lot of folks go to the outlet mall in Pigeon Forge [or] the mall in Asheville." Somewhat closer to home, the Wal-Mart Supercenter, less than 30 minutes away in Sylva, reportedly experiences a surge in sales every time tribe members receive their per-capita payments.

The 3.5 million people who visit the casino every year have spurred the development of hotels and fast-food places, but the local tourist trade doesn't see a lot of spillover effects. "We have two groups of people that come here: the gamer and the tourist," describes Joyce Dugan, Harrah's director of external relations and career development at the casino and Hicks' predecessor. Tourists might spend a little money at the casino and then see other sights. In contrast, gamers usually don't venture into the Boundary.

So, the tribal government is working with the Cherokee Preservation Foundation to revitalize the souvenir shops and other businesses downtown to make them more attractive. They are also working to reorient attractions to leverage the tribe's heritage rather than merely offer trinkets made in China or people dressed up like extras in a Western.

Once tourism is revitalized, the tribal government will turn to the difficult task of diversifying the local economy. It will do what it can to overcome the odds, including investing $1.9 million in a regional broadband network to attract technology-based businesses and providing loans to small businesses.

"The beauty of the natural environment is probably what they should focus on," suggests Todd Cherry, an Appalachian State University economist that tracks business conditions in western North Carolina. "You can do some things to create a comparative advantage, but you have to build on what you're good at." The existing tourism sector could be expanded to include golf courses or fine restaurants to appeal to different types of visitors.

Regardless of how it is accomplished, diversification will be necessary if the Eastern Band wants to keep more of its dollars within the Qualla Boundary. It will also help the tribe keep its young people when they graduate from high school.

"It will be interesting to see if this generation takes [their per-capita] money and moves away, seeing other opportunities that are bigger than what we have," says Dugan. She is optimistic that they won't. **RF**

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High Tech Down South

BY DOUG CAMPBELL

It takes a good hour to tour Research Triangle Park (RTP) by car. Across this lush 7,000 acres, two miles wide and eight miles long, are more than 100 low-slung buildings, home to some of the largest high-tech companies on the globe. IBM, GlaxoSmithKline, and Cisco Systems are just a sample of the firms employing 38,000 well-paid professionals here. Forty-six years old, RTP is arguably the world's premier research park, the envy of so many would-be technology communities and the showpiece of North Carolina's vaunted status in the New Economy.

All of which does not mask the significant challenges facing RTP in the 21st century. Employment here is down from the peak of 45,000 workers just a few years ago. Many buildings are aging and growing obsolete, with several sitting vacant. In a world where U.S. firms can tap lower-cost sources of R&D as far away as India and China, the questions about RTP mount. It is no wonder that when RTP's new president, Rick Weddle, was interviewing for the job about a year ago, a lot of friends discouraged him from taking it: "Why would you want to do that?" well-meaning colleagues asked. "Isn't RTP about finished?"

Bold Vision

In the summer of 1957, the idea of RTP being "finished" was the furthest thing from William Little's mind. It hadn't even started. Little was a 28-year-old, newly minted chemistry professor at the University of North Carolina at Chapel Hill, a native of the state who was looking forward to finally begin work as a teacher and researcher. Then his department chair asked Little to use the summertime on a novel pursuit: asking companies if they would consider opening shop in a nonexistent place between UNC, Duke University, and North Carolina State University tentatively called Research Triangle Park.

This struck Little as a superb idea. Even new to his job, he understood a chief problem facing North Carolina's economy was that many of the science and engineering graduates of its universities inevitably left for jobs in large, often Northern cities. "I couldn't do anything with my work in chemistry in North Carolina," Little says today at age 75.

So Little packed his suitcase and went calling on captains of industry in New York. The reactions were mostly positive, he recalls, but there were no immediate takers. It was in the summer of 1958 that Little hit paydirt when a top executive with Chemstrand Corp. was visiting the Chapel Hill campus on a recruiting trip for Ph.Ds. As recounted by Little and by economist Albert Link in Link's *A Generosity of Spirit: The Early History of the Research Triangle Park* Chemstrand soon ditched plans for a facility in Princeton in favor of RTP.

In 1961, Chemstrand opened for business, becoming the first major industrial tenant at RTP. Astroturf was "discovered" in Chemstrand's lab there. The firm moved some decades later, but Little remains a fixture at

In the mid-1950s, few would have imagined that the North Carolina pinelands would become home to a cluster of high-tech firms, but that was before Research Triangle Park was born

Early organizers of Research Triangle Park gather around a map of their grand plans. Among them was Romeo Guest, second from right, who is generally credited with coining the term "Research Triangle."

PHOTOGRAPHY: RESEARCH TRIANGLE FOUNDATION OF NORTH CAROLINA

RTP as both a member of its board of directors and a past leader of many of its units and organizations. A newly constructed street looping around the southern end of RTP now bears his name.

RTP would never have appeared on the map if not for extraordinary careful planning and fund-raising by some of the state's leading figures of the time.

It began to take shape in 1954. The coining of its name is credited to several sources but mostly to Romeo Guest, a Greensboro contractor who sketched the proposed location on a brown paper bag over drinks at the Richmond County Country Club. Legend has it that Guest noticed how UNC, Duke, and N.C. State formed a sort of sideways triangle. Link's *A Generosity of Spirit* relates a March 1954 meeting with Guest, Wachovia Bank President Robert Hanes, and North Carolina Treasurer Brandon Hodges whose stated purpose was the need for industrial growth but turned into Guest's pitch for Research Triangle Park. A year later, Gov. Luther Hodges (no relation to Brandon) established the Research Triangle Development Council, which quickly became the Research Triangle Committee.

In a description that holds up to this day, Hodges once described the committee's vision for RTP as encompassing three things: the actual tract of land, the three universities themselves, and "... an idea that has produced a reality — the idea that the brains and talents of the three institutions, and their life of research in many fields, could provide the background and stimulation of research for the benefit of the state and nation."

Laying the Foundation

Between 1957 and 1959, the park's journey from dream to reality was driven by two key businessmen. The first was Karl Robbins, a New York industrialist who agreed to put up $1 million to acquire land in what became RTP, eventually amassing 3,559 acres he outright controlled or had options to under the name "Pinelands Co." The second was Archie Davis, who succeeded Hanes at the helm of Wachovia and raised $1.25 million in just 60 days to buyout Robbins in 1959. About 20 percent of the funds came from the Raleigh-Durham-Chapel Hill area, but the rest were from donors scattered across the state, all anonymous at the time. Pinelands became the Research Triangle Foundation, which endures today as the park's administrator.

Chemstrand was a significant addition, as was the official first tenant, the Research Triangle Institute, a contract research group. But between 1960 and 1965, no other big fish were landed, and people started to whisper about the park's prospects for survival. "There was skepticism and paranoia," Little says, summing up the local mood.

By 1965, the skepticism was history thanks to two enormous recruiting wins. The first was what became known as the National Institute of Environmental Health Sciences (NIEHS), which RTP agents had been pursuing for four years. The project, announced in January 1965, was valued at $70 million and remains the nation's center of studying environmental causes of human illness. UNC's School of Public Health, along with then-Gov. Terry Sanford's earlier support of John F. Kennedy's presidential bid, were believed to be key factors in the location decision.

Three months later came news that International Business Machines would build a 600,000 square-foot research lab at the park. IBM had been courted for seven years, according to Link. As Little tells it, IBM was persuaded in part by a UNC professor, Fred Brooks, who previously had worked as one of IBM's top researchers and developed the System/360 family of computers and Operating System/360 software. IBM today remains RTP's largest employer, with 11,000 workers at its campus.

After IBM and NIEHS, 21 more companies located in the park by 1969, followed by 17 more in the 1970s, 28 more in the 1980s and a booming 42 organizations in the 1990s. Employment leaped to more than 30,000 by 1990. The Triangle Universities Center for Advanced Studies, known around campus as TUCASI, was set up in 1975 by the RTP Foundation for the explicit purpose of keeping the three universities working together. Late that same year, the American Academy of Arts and Sciences agreed to locate the National Humanities Center on the TUCASI campus.

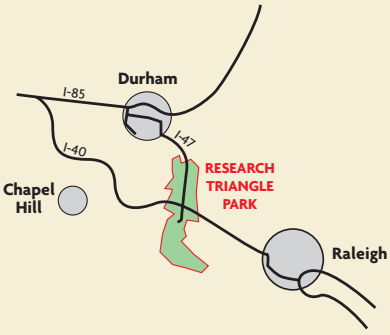
An Unparalleled Success

Today all but 1,100 acres of the 7,000-acre park are developed. There are some 120 research organizations and companies. There are 13 miles of paved jogging trails and a "town center" with banks, restaurants, and a hotel. The park requires organizations to build on only 15 percent of their total property with wide setbacks from the street, making the area seem almost bucolic, with buildings hidden from the roadway. The total park payroll is estimated at $2.7 billion, making the average salary about $56,000.

Nobody accused former UNC System President Bill Friday of exaggeration when he said: "Research Triangle Park is the most significant

RESEARCH TRIANGLE PARK

Spanning 7,000 acres, Research Triangle Park is home to more than 100 research and development firms, many of which tap the nearby resources of the three universities that make up the Triangle: Duke University in Durham, the University of North Carolina in Chapel Hill, and North Carolina State University in Raleigh.



SOURCE: Research Triangle Foundation of North Carolina

economic and political manifestation of will in the state in the last century." Such is the park's cachet that firms as far as 30 miles away have claimed RTP post office boxes so they can put "Research Triangle Park" and its famed 27709 ZIP code on their letterhead. (Equally, many firms just outside the official park borders still call themselves RTP tenants, and they have become a de facto part of the wider Research Triangle community.) A tenant tells the story of visiting Germany recently and telling the host that his organization had recently located in North Carolina. The host nodded knowingly and said: "Yes, we know about North Carolina. It's in the Research Triangle Park."

RTP's wider economic impact is hard to overstate. In a 1999 report, a consulting firm estimated that more than $300 million of private investment was generated in plants in the 10 counties surrounding the Triangle during the 1990s. Employment in "new line, technology-related" industries grew from 15 percent of all jobs in the region to almost half by the end of the 20th century.

The precise reasons RTP succeeded while so many other similarly aimed projects have faltered remains a bit of a mystery. The timing was good, with Sputnik's orbit in 1956 having sparked government enthusiasm for research. The advent of air conditioning also made year-round working in the South more practical and comfortable. RTP wasn't the first research park — Stanford Research Park, for instance, was founded in 1951 — but it was one of the first, and as such achieved crucial "first-mover" advantage over would-be competitors.

In his histories of the park, Prof. Link cites three obvious factors in RTP's favor: "dedicated people, three outstanding universities, and a world-class research institute." But to Link, the key is the presence of the research institute TUCASI — without it, an official forum for the three universities to cooperate wouldn't exist. It is the convergence of the three schools, the combining of their talents and resources, that has propelled RTP to the top, Link believes. "There is one unique aspect of the infrastructure of the park unrivaled by any park in this country, and that is TUCASI."

The Future

The present-day state of RTP also contains some troubling signs: old, vacant buildings and an economy that no longer seems to favor geographic clusters the way it used to. Which brings us back to Rick Weddle, who took over the job of RTP president after his predecessor, Jim Roberson, retired in July 2004. When people ask him, "Isn't it about finished?" Weddle is adamant in his response: "The reality of the matter is it is just now beginning."

Here is what Weddle is selling: RTP is not in a city; its area is 75 percent in Durham County and 25 percent in Wake County. Thus, landowners don't pay municipal property taxes, just those of the county. They are also members of the park's owners and tenants association, which is like a big homeowners association that helps manage growth. Tenants are part of a special tax district whose rate is about 2 cents per every $100 of property valuation — adding, for example, $2,000 to the annual tax bill for a firm with a $10 million lab. The RTP Foundation, which is funded chiefly by the land liquidations valued at $3 million annually, is a service unit whose job is "to wake up each and every single day thinking about how to add value to a defined set of companies," Weddle says.

University access is by no means the exclusive right of RTP tenants, but the park remains a central hub for interaction among UNC, Duke, and N.C. State, and the university presidents sit on the RTP Foundation board.

Weddle sees an RTP where none of the workers have to drive on Interstate 40 to get to their offices, because they'll be able to ride a high-speed rail into the park and walk the rest of the way. He sees residential development, for the first time, inside park borders, along with new retail options. But the focus is shifting from just selling land to "harmonizing the knowledge assets in the region," which means throwing the weight of RTP — the brand — beyond park borders and across its wider sphere of influence.

The payoff, Weddle says, will be that the park can grow so that it employs as many as 90,000 people under current density rules; should those rules be loosened, as many as 150,000 jobs are envisioned. Weddle wants to steer RTP from being known as solely the home of large-facility, multinational organizations to one having a portfolio of diverse firms, spanning industries and sizes, from startups to mature cash cows.

It sounds incredible. The only thing keeping people form guffawing at Weddle is the position from where he sits. There remains nothing else quite like Research Triangle Park. So Weddle feels perfectly justified in saying things like: "I'm excited and optimistic because I still see most of the world trying to copy the *way we were*. That gives us the opportunity to begin to develop the *way we're going to be*." **RF**

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INTERVIEW

Robert Whaples

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

Economists are sometimes accused of being more interested in high theory than in explaining real-world events. This may be correct in select cases, but it's questionable as a general proposition. And when it comes to economic historians, the opposite is probably closer to the truth. Their research seeks to explain how and why things developed over time, and to do so they employ the tools not only of modern economics but also of many related disciplines.

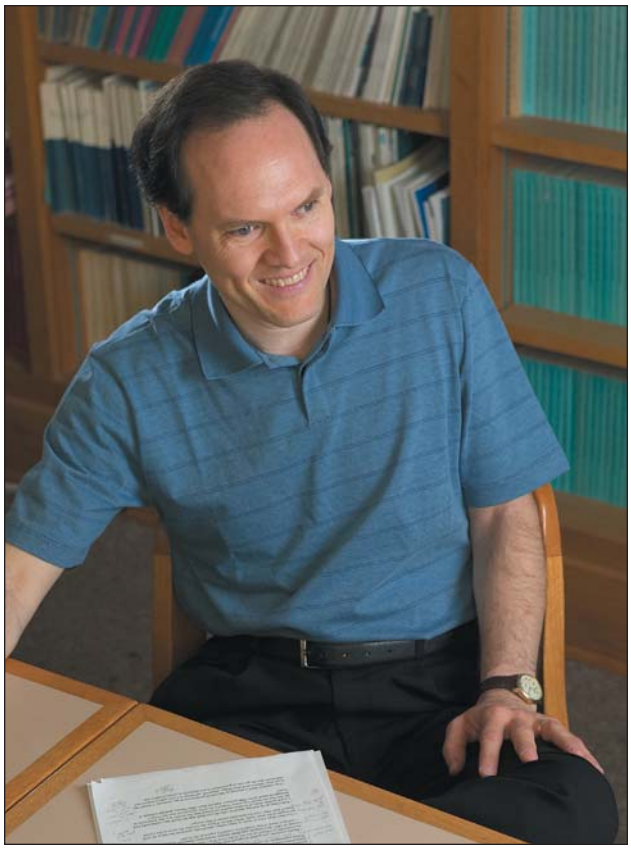
Economic historian Robert Whaples of Wake Forest University is no exception. His research on labor markets, for instance, examines the economic, political, social, and ideological factors that shape the way Americans work. He also has written a number of papers that explore where there is consensus among economic historians and where there is significant disagreement.

Whaples has received two major awards from the Economic History Association. In 1990, he was awarded the Allen Nevins Prize, given annually to the best doctoral dissertation in the field of American and Canadian economic history, for his work on the shortening of the workweek. And in 1999, he won the Jonathan Hughes Prize for Excellence in Teaching Economic History. In addition, Whaples is director of EH.Net, which provides extensive online resources for economic historians and students.

Aaron Steelman interviewed Whaples on the Wake Forest campus on May 23, 2005.

RF: I want to ask a few questions about your 1995 article in the *Journal of Economic History*, "Where Is There Consensus Among American Economic Historians? The Results of a Survey on Forty Propositions." In some areas, there is general agreement among the professional economists and the professional historians polled, while on others there is a pretty sharp division. Were you surprised by this?

Whaples: I was not surprised by the differences that I found. I was more surprised by how much agreement there was between the two disciplines. I spent the first few years of my career teaching in a history department, and I found that many historians have little understanding of or appreciation for how markets work. This is in contrast to economists. Even those economists who are inclined to believe that the government has an important role to play in the economy still tend to think that people are rational actors and that markets are generally efficient. So I thought that the divergence between economic historians who were trained principally as historians and those who were trained principally as economists would be larger than they were.



PHOTOGRAPHY: KEN BENNETT/WAKE FOREST UNIVERSITY

RF: More than half of the economists polled disagreed with the proposition that "monetary forces were the primary cause of the Great Depression." Why do you think there is a probable disconnect on this issue between economists who specialize in monetary issues — most of whom would likely answer that question in the affirmative — and economic historians?

Whaples: My sense is that economic historians are likely to have done more extensive reading about that time period and the very complex nature of the phenomenon. They wouldn't deny that monetary forces were very important, but they are likely to consider all of these other things that were going on. So it may largely be a semantic issue, with the economic historians less likely to describe *anything* as the "primary cause" of the Great Depression, because they attribute it to a constellation of events.

RF: Staying on the topic of the Great Depression, the economists polled were significantly more likely than the historians to agree that the "New Deal served to lengthen and deepen" the economic problems of the late 1920s and the 1930s. What is your view on this question?

Whaples: First, I should say that it is a very provocative question, and it elicited an interesting response. The finding was almost an even split among the economists polled. Forty-nine percent either agreed, or agreed with provisos, that the New Deal "served to lengthen and deepen the Great Depression," while 51 percent disagreed. So there's a large share of economists who think that the New Deal wasn't such a good deal.

Why? There are some New Deal programs that many economic historians see as major blunders. At the top of the list is the National Industrial Recovery Act, which cartelized the economy just as it was getting off the ground, leading to lower output, consumption, and employment. If you look at the quarter-by-quarter estimates — they're not perfect, but they do shed some light on this time — by 1933 the economy was starting to come back pretty rapidly. Then the NIRA was passed, and by the last quarter of 1933, the economy started to go down.

There are other programs that many economic historians look at critically. They may have had some desirable effects, but probably slowed down the recovery. One is the Wagner Act, which led to the sit-down strikes and labor unrest. Another is the Social Security Act, which increased the tax burden when many people believed that a fiscal stimulus was needed. By 1937 the economy really slowed down again, leading to what has been called the "Roosevelt recession." So many economic historians believe that there were a number of missteps taken during the New Deal, and I would tend to agree.

There are some New Deal programs that many economic historians see as major blunders.

RF: Following the Civil War, it took a significant amount of time for the Southern economy to converge to Northern levels. There have been several ideas offered to explain why that was the case. Which explanation, or combination of explanations, do you find most convincing?

Whaples: At the time the Civil War began, the South was not behind the rest of the country economically, but afterward, living standards were well below those in the North. The question is: Why? Many parts of the South were decimated by the war, and the destruction of capital certainly played a role. But this does not explain why things took so long to turn around. The abolition of slavery was certainly important. Freed slaves decided to work less and consume more leisure. Also, the price of cotton was near an all-time high before the war but then declined for most of the rest of the century. So that hurt the South's economy and is part of the story.

My favorite interpretation of what happened following the Civil War, and I think it's probably the profession's favorite interpretation, is pretty akin to what Gavin Wright has argued in *Old South, New South*. It emphasizes the lack of integration, especially in the labor market and also in the capital market.

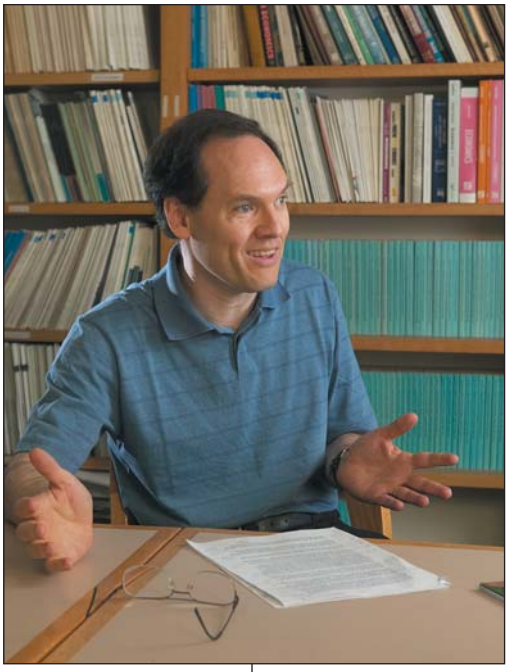
Labor really did not come out of the South, mainly for cultural reasons and perhaps for some economic reasons. Capital was less willing to come into the South, partly because at this time you often needed to have the managers migrating with the capital, and many were unwilling to do so. One reason was climatic: This was before the invention of air-conditioning. Another was cultural: We just don't like the way they do things down here and we're not really well accepted. I have stated the story in pretty crude terms, but that's the flavor of the argument, and I think it's pretty persuasive.

RF: But wouldn't we expect capital to flow to where the returns are the highest, even if there are some cultural institutions in the South that Northern investors find unappealing?

Whaples: I think that there are clearly some examples of this. If the return on capital was high enough, it did move to the South. Take the region around Birmingham, Ala., for instance. There were some very good iron deposits around that area, which made it a natural place for steel production. The textile industry moved to the Carolinas, largely from New England, New York, and New Jersey. But in marginal cases, where the returns were likely to be similar to those in the North, capital didn't tend to flow south.

Also, I would like to make a more general point about the economy of the post-bellum South. There are some very important regional differences. Prior to the Civil War, the

poorest part of the South is where we are today: North Carolina. And the richest parts were the cotton areas near the Mississippi Delta. Now, that situation is essentially reversed.



RF: Nearly everyone you polled disagreed with the proposition that "the slave system was economically moribund on the eve of the Civil War." Had the South been permitted to secede in 1861, how long do you think slavery would have remained economically viable?

Whaples: This is pretty interesting. The belief that slavery was on its way out prior to the Civil War was widely respected and accepted for a long time — from the end of the Civil War until the 1950s or so. But since then, more rigorous models have shown that the returns that slaveowners received were pretty large. So if you are looking at it purely from an economic standpoint, it's hard to say that the system was moribund.

How long would slavery have lasted had the Civil War not occurred? I began to think about that, and all you really need is a system in which the marginal revenue product of labor is high enough to cover the maintenance cost. A slaveowner would have approached this question in the same way that he would have considered the issue of using mules and horses following the invention of the automobile. When the automobile and tractor came along, using draft animals was no longer economically viable, and so many owners just let those animals go. That's a system that is moribund.

Would that have happened in the human system? I don't think so. Human beings are so much more flexible and adaptable that slaves could have been put to many other uses once the cotton industry had become mechanized and people were no longer needed in large numbers. In fact, we know that before the Civil War there was a lot of industrial slavery. Slaves were moved from farms to factories as the latter became more profitable. I think that would have continued to be the case, with slaves being used in a variety of agricultural, industrial, and even service-sector jobs.

So, economically, I think slavery could have remained viable for a very long time after the Civil War. What would have probably undermined the system was the reduced cost of transportation and communication. As it became cheaper and easier to escape from bondage, the costs of monitoring slaves probably would have become prohibitively large.

RF: You have done a lot of work on labor issues, specifically questions having to do with the length of the workweek. When did the eight-hour day become the norm in the United States? And what were the principal causes of this change?

Whaples: The best documentation we have about the length of the workweek comes from the manufacturing sector. In the mid-19th century, the workweeks were very long. But then they came down fairly rapidly. By the end of World War I, we effectively had the eight-hour day. It wasn't quite in the form that we recognize today, because the workweek was generally six days. That stayed the norm until the Great Depression, when a lot of Saturday work ended. Work schedules became considerably longer during World War II. But in the main, the typical workweek has been five eight-hour days since the 1930s. So it did come sooner than many people think, and it did predate the Fair Labor Standards Act, which gave us the overtime law in 1938.

My research on this topic strongly suggests that the cause of the shorter workweek was economic growth, which led to higher real wages. But I think we have to put that answer into the context of the time in which it occurred, because we have had substantial growth in real wages since then, yet we haven't seen the length of the workweek go down even more.

So what was occurring during the late 1800s and early 1900s? I think it had to do with the marginal utility of an extra hour of leisure being incredibly high during that period. Many people were doing pretty onerous work. There were many mind-numbing routine jobs and many jobs that required back-breaking physical labor. But we don't have a great number of those jobs in our economy any longer. In fact, a lot of us have jobs where the distinction between work and leisure gets a little fuzzy. Well, it wasn't fuzzy back then, and boy, did they want those extra hours off to relax, spend time with their families, and hang out with the guys. So as wages got higher, they bought more of this leisure time. Any other economic factor is so secondary to this that I don't even think it's worth mentioning.

Also, I think it's worth mentioning that although the workweek hasn't gotten shorter in recent years — in fact, for more educated and skilled workers there is some evidence that it has gotten longer — the total share of a person's life spent working for pay has continued to fall. People enter the labor force at later ages, they retire earlier, and they live longer. All of these things have contributed to more leisure consumption.

RF: Why do you think that the South has traditionally had a smaller share of its labor market unionized than the North?

Whaples: Whenever I teach labor economics, I pull out data on unionization rates from the Bureau of Labor Statistics. And it's always a battle between North Carolina and South Carolina for who has the lowest share.

Unionization rates have always been lower in the South than in the rest of the country. One explanation is the nature of the region's economy: Agriculture has traditionally been more important to the South, and that sector typically has pretty low unionization rates. Going beyond that, I think there are some important cultural factors. When unions are really strong, there is a sense among workers that it's us versus them, labor versus management. In the North, the workers were often a group of immigrants, while the management was often the native-born, better-educated elite. In the South, there was much less of that. The division was black versus white, and culturally the white workers identified with management. So there was much less of an us-versus-them mentality. That, I think, has a lot to do with the relative weakness of labor unions in the South.

RF: You have co-edited a book titled *Public Choice Interpretations of Economic History*. What insights can public choice bring to bear on economic history?

Whaples: I think the best way to answer that question may be to discuss my favorite chapter from that book. Werner Troesken of the University of Pittsburgh looks at the passage of the Sherman Antitrust Act. He analyzes what happened to the stock prices of the big trusts at the time. What he shows, pretty convincingly, is that the value of those companies' stocks were rising as it became more and more certain that the Sherman Antitrust Act was going to be passed. So the markets clearly thought that the law was going to be good for the very companies whose power, ostensibly, it was designed to curb. That might seem pretty counterintuitive to many, but it's an interpretation that a public-choice economist would find pretty intuitive.

RF: Please tell our readers a little bit about EH.Net and your role in it.

Whaples: EH.Net grew out of the Cliometric Society. It started as an online discussion group among members of the Society in 1994, in the early days of the Internet. We found that this was useful, but we wanted to make it more permanent. And we thought that the way to do that was to make it an independent organization, and one that offered a lot more than a simple online discussion forum. So we held a meeting in 1996, where we chartered ourselves as a new organization, with Samuel Williamson of Miami University as the director and myself as the associate director. Our division of labor was the following: Sam was the fund-raiser and principal organizer, and I focused on adding content to the Web site.

There are several things that we offer. Perhaps the most important is our "How Much Is That?" feature, which allows people to obtain historical data on inflation rates, exchange rates, economic output, the cost of labor, purchasing power, and a number of other data series. We also have an encyclopedia that is aimed at students and lay readers. The entries discuss the big issues in economic history — slavery, the Civil War, and the Great Depression, for instance — as well as more offbeat topics like prohibition and Major League Baseball.

There are about 100 articles in the encyclopedia, and the idea is to get the research that is published in the professional journals out there to the public. So much of it is holed up in academic libraries, when we think there is a much broader audience for it. The other big thing we have is a book review section. We now have reviewed about 1,000 books over the years. Most of them have come through my office, and we try to be comprehensive in our coverage. We aim to review everything that is published in the core areas of economic history, and many books that are in more peripheral areas.

As for the organization, in 2003 the Economic History Association became the owner of EH.Net. Also, I became the director that year, though Sam Williamson is still quite active. And I'm proud to say that my son, Thomas, who is a student at Wake Forest, is EH.Net's webmaster.

RF: Which economists have influenced you the most?

Whaples: Probably the economist who has influenced me the most is Gary Becker. By applying the assumption that individuals are rational and utility-maximizing to areas once thought beyond the scope of economics, he has helped us better understand so many facets of life. Among economic historians, Robert Fogel is probably the most influential. His relentless quantification, his willingness to be so interdisciplinary in his work, and his extreme optimism are things that I find extremely admirable. Closer to home, the people on my dissertation committee — Claudia Goldin, Robert Margo, and Paul Taubman — have been very important to me. Also, I should note Gavin Wright and Joel Mokyr. When I read them, I learn more about how to be an economic historian. **RF**

Robert Whaples

➤ Present Position
Professor of Economics, Wake Forest University, and Director of EH.Net

➤ Previous Faculty Appointments
Department of History, University of Wisconsin-Milwaukee (1988-1991)

➤ Education
B.A., University of Maryland (1983); Ph.D., University of Pennsylvania (1990)

➤ Selected Publications
Author of several articles in the *Journal of Economic History* and other academic journals, and co-editor of two books, *Historical Perspectives on the American Economy* (1995) and *Public Choice Interpretations of American Economic History* (1999)

BookReview

The Relentless Pursuit of Incentives

FREAKONOMICS: A ROGUE ECONOMIST EXPLORES THE HIDDEN SIDE OF EVERYTHING

BY STEVEN D. LEVITT AND STEPHEN J. DUBNER

NEW YORK: WILLIAM MORROW, 2005, 242 PAGES

REVIEWED BY AARON STEELMAN

It's rare that a book on economics makes the best-seller lists. But *Freakonomics: A Rogue Economist Explores the Hidden Side of Everything* by Steven Levitt and Stephen Dubner has been there for several months and shows no signs of leaving.

Levitt is an economist at the University of Chicago who in 2003 won the John Bates Clark Medal, given every two years to the top American economist under the age of 40. Dubner is a journalist, who wrote a profile of Levitt in the *New York Times Magazine* the same year. That article began with the following passage:

The most brilliant young economist in America — the one so deemed, at least, by a jury of his elders — brakes to a stop at a traffic light on Chicago's South Side.

It is a sunny day in mid-June. He drives an aging green Chevy Cavalier with a dusty dashboard and a window that doesn't quite shut, producing a dull roar at highway speeds.

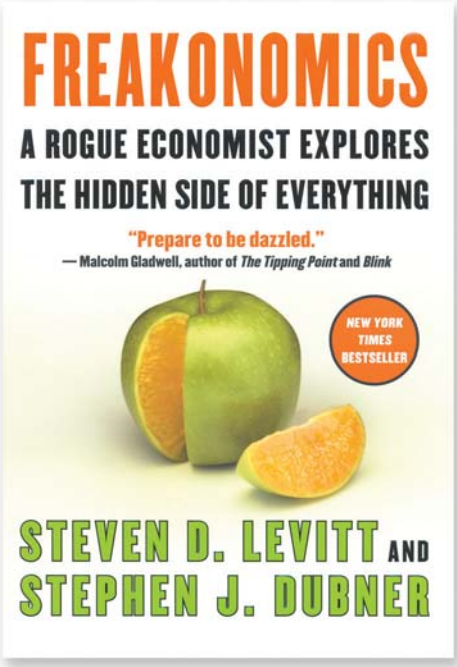
But the car is quiet for now, as are the noontime streets: gas stations, boundless concrete, brick buildings with plywood windows.

An elderly homeless man approaches. It says he is homeless right on his sign, which also asks for money. He wears a torn jacket, too heavy for the warm day, and a grimy red baseball cap.

The economist doesn't lock his doors or inch the car forward. Nor does he go scrounging for spare change. He just watches, as if through one-way glass. After a while, the homeless man moves along.

"He had nice headphones," says the economist, still watching in the rearview mirror. "Well, nicer than the ones I have. Otherwise, it doesn't look like he has many assets."

Steven Levitt tends to see things differently than the average person. Differently, too, than the average economist. This is either a wonderful trait or a troubling one, depending on how you feel about economists.



Such puzzles — why a homeless man would have $50 headphones, for example — are the type of thing that interests Levitt. And presumably those eclectic interests are what intrigued Dubner and the *New York Times Magazine* about Levitt. He doesn't try to answer sweeping macroeconomic questions or offer an opinion on where the economy is heading in the next year. In fact, if you were to ask him about such topics, he would probably say that your guess is as good as his. Instead, Levitt has made a name for himself through careful empirical examination of microeconomic questions.

Unusual Topics, Conventional Methods

Many of those questions might seem beyond the scope of economics. But as Levitt and Dubner write, "the science of economics is primarily a set of tools, as opposed to a subject matter," and this means that "no subject, however offbeat, need be beyond its reach." Fine, you might say. Still, aren't some of those offbeat subjects — such as why African-American parents often give their children distinctively "black names" — frivolous compared to more conventional topics of economic inquiry? That's a judgment call. But looking at seemingly frivolous topics can help us better appreciate the role of incentives, which Levitt and Dubner rightly claim are "the cornerstone of modern life. And understanding them — or, often ferreting them out — is the key to solving just about any riddle."

Indeed, if there is a unifying theme to Levitt's work, it's the belief that incentives guide individual people's lives and in the process shape the course of society. Levitt is not unique in this way. All economists think that incentives matter. But Levitt is relentless in the application of this principle, and that has led him to some controversial conclusions.

Safer Cities

Before the publication of *Freakonomics*, Levitt was probably best known for his work on the declining crime rates of the 1990s, research that he and Dubner discuss in Chapter 4 of the book. At the beginning of that decade, violent crime was wreaking havoc in America's cities, and many social scientists and policymakers claimed that things were only going

to get worse. As late as 1997, with crime rates already on a steady downward trend, President Clinton warned that "we've got about six years to turn this juvenile crime thing around or our country is going to be living with chaos. And my successors will not be giving speeches about the wonderful opportunities of the global economy; they'll be trying to keep body and soul together for people on the streets of these cities."

Fortunately, this dire prediction did not come to pass. Crime rates in the United States continued to fall sharply, and instead of writing about the emergence of "superpredators," the media focused its attention instead on how some of America's once-doomed cities — New York, in particular — had become much safer places to live. The suburbs, which had once been seen as a safety valve for parents too afraid to take their kids to Central Park, were now viewed by many commentators as a scourge. Within just a few years, the media went from lamenting the perils of America's urban centers to criticizing suburban sprawl.

What led to the decline in crime rates? According to many of the social scientists and policymakers who earlier had predicted that we were on the cusp of an urban apocalypse, it was a confluence of three factors: a growing economy; tougher policing, including a "no-tolerance" policy for many lesser crimes; and more restrictive gun-control laws. All three were plausible explanations. And all were things for which the social scientists and policymakers were happy to claim credit; it was their ideas, they said, that finally brought crime under control.

But when Levitt looked at the data, he doubted the importance of those oft-cited factors. They may have been part of the story, but he argued that there was a much more important factor behind the drop in crime: legalized abortion. In January 1973, the Supreme Court issued its decision in *Roe v. Wade*. Afterward, abortions were much easier and cheaper to obtain in the United States.

What does this have to do with falling crime rates? Think of it as a three-step process. First, children from dysfunctional households are more likely to become criminals. Second, those women who had foregone illegal abortions because of their expense were more likely to come from dysfunctional households. Third, following *Roe v. Wade*, many of the women who before would have given birth ended their pregnancies instead. The result, according to Levitt and Dubner, is that "the pool of potential criminals had dramatically shrunk." So by the mid-1990s, "just as these unborn children would have entered their criminal primes, the rate of crime began to plummet."

For people who believe that abortion is evil, this may be a difficult conclusion to accept. But in this case, acceptance doesn't mean approval. One could accept Levitt's argument as an empirical truth while still believing that abortion is ethically wrong. Nor does it mean that you have to argue that every child born into a dysfunctional household will become a criminal. Indeed, most of us probably know cases to the contrary. What accepting this argument does require, though, is an openness to scientific inquiry, no matter where the data may lead you. Levitt and Dubner write: "Morality, it could be argued, represents the way that people would like the world to work — whereas economics represents how it actually *does* work."

That idea is on display throughout the rest of the book, as the authors examine a host of other questions. For instance, they discuss why school teachers may help their students cheat on standardized exams, and how administrators can tell when this is happening. They consider whether a real estate agent can be expected to act in a home-seller's best interest. And they dissect the internal organization of a drug-selling gang.

> Economics is primarily a set of tools, as opposed to a subject matter.
>
> — Steven Levitt And Stephen Dubner

Nearly all of the topics in the book come from articles that Levitt wrote for professional economic journals. Those articles have been reworked for a nontechnical audience, but remain true to the original ideas. In short, Levitt and Dubner faithfully present the logic, while eschewing the math.

What's in a Name?

Which brings me to the title — *Freakonomics: A Rogue Economist Explores the Hidden Side of Everything*. Many economists have criticized this choice. How, they ask, could Steven Levitt, winner of the John Bates Clark Medal, possibly be considered a "rogue" economist? After all, it's one of the most prestigious prizes in the profession, and many past winners have gone on to win the Nobel Prize. Levitt, they say, is anything but an outsider.

These critics are both right and wrong. It is a misleading title. The topics Levitt chooses may be unconventional, but his methods are certainly mainstream. At bottom, he is a neoclassical economist — no doubt a uniquely talented one, but this doesn't lend him rogue status. Also, at points throughout the book, the authors talk about freakonomics as a "field" of study. But it's not. What Levitt does is use microeconomics to answer interesting questions. That hardly makes for a new field, a point the authors admit when they argue that economics is about the tools that its practitioners use, not the topics they choose.

Still, it's hard to be too critical of the title. It almost certainly has made the book easier to market, resulting in more copies being sold and Levitt's ideas being presented to a wider audience. Hopefully, some of those readers will discover that economics is not such a dismal science — that it offers powerful ways to look at the world in all its dimensions. If so, the costs of the book's misleading title surely will be outweighed by its benefits. **RF**

District Economic Overview

BY ROBERT LACY

The Fifth District economy expanded at a fairly strong pace in the first quarter of 2005. Services businesses generally reported solid gains in revenues, manufacturers said that shipments and new orders were up (albeit modestly in some cases), and employment and personal income rose in District states. Although growth in output and employment in the services sector slowed toward the end of the quarter, the District economy retained considerable momentum heading into the spring.

> The Fifth District economy expanded at a relatively strong pace in the first quarter of 2005, but momentum slowed by the end of the quarter.

Growth Continues

Services businesses generally reported higher sales and expanded payrolls in the first quarter. Home sales and residential building activity were particularly brisk, and commercial real estate activity picked up in a number of areas. Financial institutions reported higher lending activity as well.

Retail sales, however, were a little softer in the first quarter. Shopper traffic and sales growth began to slow in February, and by March an increasing number of retailers were reporting stagnant sales. Retailers said rainy weather and substantially higher gasoline prices contributed to March's malaise.

Manufacturing output rose in the first quarter, but the pace of expansion remained generally modest. New orders and shipments were somewhat higher while capacity utilization was flat. Manufacturing employment, on the other hand, edged lower; 16,000 jobs were trimmed from payrolls in the first quarter. The textiles and apparel sectors, which employ one in seven of the District's manufacturing workers, will likely contract further in 2005 as imports are expected to gain even greater shares of the U.S. market.

District Gains Jobs

Despite the loss in manufacturing jobs, first-quarter payroll employment in the Fifth District was 1.4 percent higher than a year ago. This was slightly off the pace of the second half of 2004 and somewhat short of the rate of expansion nationwide. Slow employment growth in South Carolina accounted for some of the difference between the U.S. and the District's growth rates. South Carolina payroll employment rose by a meager 2,200 jobs year over year, and jobs in the health services and education sector fell compared to a year ago.

The unemployment rate in the District edged lower — from 4.9 percent to 4.8 percent in the first quarter. Virginia's unemployment rate dipped to 3.3 percent, among the lowest rates in the nation. Rates of unemployment in Maryland, North Carolina, and West Virginia were relatively low as well, and below the U.S. average of 5.3 percent for the quarter.

Energy Prices Jump

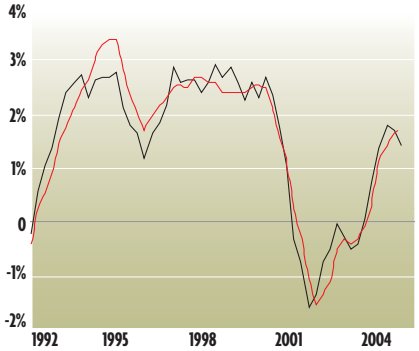
Higher energy prices filtered through the Fifth District economy in the first quarter. Manufacturers, public utilities, and transportation firms in particular endured substantially higher energy costs during the period. Businesses with little pricing power, especially textiles and apparel firms, saw their profit margins squeezed as higher petroleum prices raised raw materials costs.

Other firms were able to pass at least some of their higher energy costs on to their customers. Consumers throughout the District grumbled as gasoline prices rose above $2.00 per gallon at the pump in the first quarter. According to the consumer price index for the Washington, D.C.-Baltimore metropolitan area, energy prices in March 2005 were 14 percent higher than a year earlier.

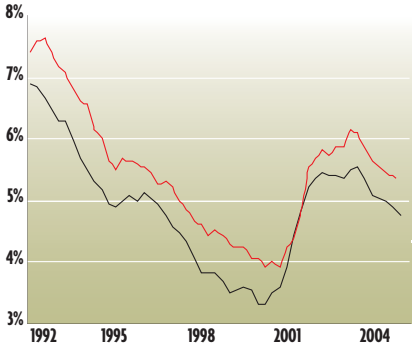
Economic Indicators

	1st Qtr. 2005	1st Qtr. 2004	Percent Change (Year Ago)
Nonfarm Employment (000)			
Fifth District	13,262	13,074	1.4
U.S.	132,822	130,541	1.7
Real Personal Income ($bil)			
Fifth District	885.4	844.6	4.8
U.S.	9,232.7	8,838.9	4.5
Building Permits (000)			
Fifth District	57.9	54.0	7.2
U.S.	469.2	442.4	6.0
Unemployment Rate (%)			
Fifth District	4.8%	5.1%	
U.S.	5.3%	5.7%	

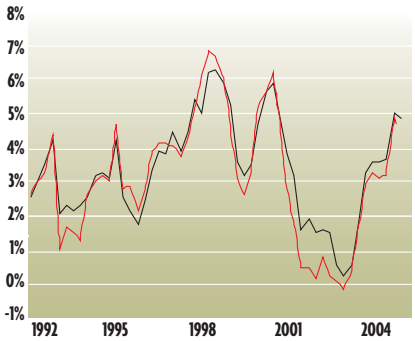
Nonfarm Employment
Change From Prior Year
First Quarter 1992 - First Quarter 2005



Unemployment Rate
First Quarter 1992 - First Quarter 2005

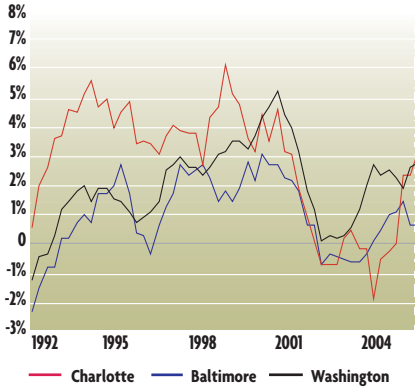


Real Personal Income
Change From Prior Year
First Quarter 1992 - First Quarter 2005

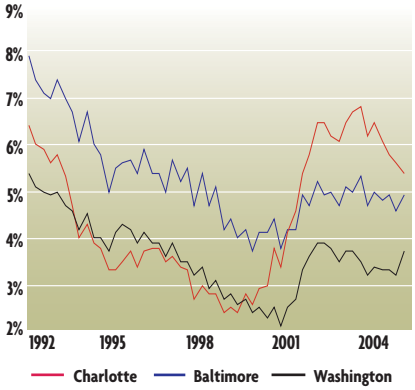


Fifth District — United States

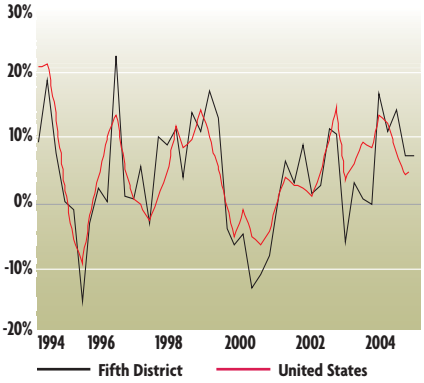
Nonfarm Employment Metropolitan Areas
Change From Prior Year
First Quarter 1992 - First Quarter 2005



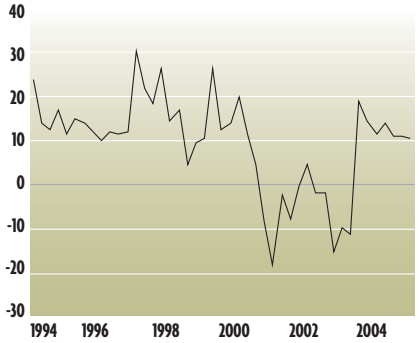
Unemployment Rate Metropolitan Areas
First Quarter 1992 - First Quarter 2005



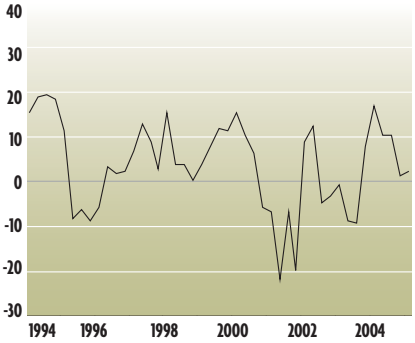
Building Permits
Change From Prior Year
First Quarter 1994 - First Quarter 2005



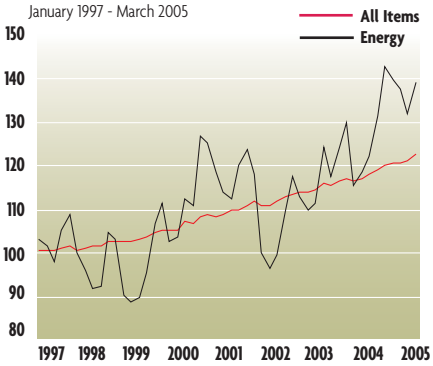
FRB—Richmond Services Revenues Index
First Quarter 1994 - First Quarter 2005



FRB—Richmond Manufacturing Composite Index
First Quarter 1994 - First Quarter 2005



Washington DC—Baltimore Metro Area Consumer Price Index
January 1997 - March 2005



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

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.
Building permits: U.S. Census Bureau, http://www.census.gov.
Consumer price index: Bureau of Labor Statistics, http://stats.bls.gov.

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

State Economic Conditions

BY ANDREA HOLLAND

District of Columbia

Economic conditions in the District of Columbia continued to gain momentum in early 2005. The first quarter saw a pickup in payrolls as well as a decline in the jobless rate and number of initial unemployment insurance claims. On the business front, venture capital investment followed the national trend and waned somewhat, but the residential and commercial real estate markets forged ahead.

DC Home Sales, Q1:00-Q1:05

NOTE: Shaded Area Represents Recessionary Period
SOURCE: Sales of Existing Housing Units, National Association of Realtors®

District of Columbia payrolls expanded 1.1 percent in the first quarter of 2005. Strong gains in the leisure and hospitality sector — boosted in part by National Cherry Blossom Festival-related tourism — offset modest job losses in other industry sectors. According to the Richmond Fed's most recent Beige Book, more than 1 million tourists attended the 93rd annual Cherry Blossom parade, a record for the event.

Indicators of household labor market conditions, such as initial unemployment insurance claims and the jobless rate, also showed improvement in the first quarter. Initial claims dropped 4.4 percent, a steeper decline than in most other Fifth District jurisdictions. The jobless rate also posted a significant drop — 0.7 percentage point — though much of the downward adjustment stemmed from the annual benchmark revision.

Venture capital investment was flat — the most recent data showed no venture investment activity in the District of Columbia between January and March of this year. The District of Columbia was not alone, though — 15 states nationwide also reported flat activity in the first quarter.

In real estate, the District of Columbia's residential market continued to gain ground in the first quarter. New building permit authorizations advanced strongly over the year as did sales of existing homes, which outpaced last year's level by 0.7 percent. Compared to other Fifth District jurisdictions, however, home sales in the District of Columbia advanced more slowly, possibly due in part to escalating home prices. In the first quarter alone, prices shot up by 11.3 percent, bringing the four-quarter growth rate to 22.2 percent. As such, the District of Columbia ranked fourth nationwide in terms of price gains.

Maryland

Maryland's economy grew on pace in the first quarter. The latest economic reports showed a rebound in job numbers and continued strength in the residential real estate market. Private investment into state businesses, however, expanded at a slower clip.

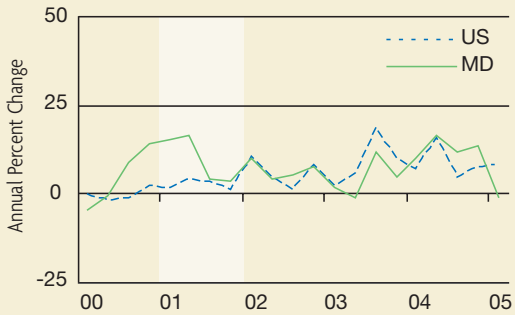
According to the Bureau of Labor Statistics, business hiring in Maryland continued to accelerate in the first quarter. Payrolls in the state expanded by 1.8 percent — or 11,067 jobs — accounting for nearly half of the Fifth District's total job growth. By sector, the bulk of the job creation came from the services side of the economy, with only the information sector reporting losses. In contrast, payrolls were trimmed across the board at goods-related establishments in the first quarter.

Tracking the pickup in hiring, initial unemployment insurance claims filed by Maryland residents fell 0.6 percent in early 2005 — encouraging, but less than the 5.4 percent decline recorded nationwide. Also little changed was unemployment. Maryland's jobless rate came in at 4.2 percent in the first quarter, matching the measures of both the prior quarter and a year earlier.

Compared to the state, employment activity in the Baltimore metropolitan statistical area was less bright. Metro area firms trimmed jobs by 7.6 percent in the first quarter, and the jobless rate inched 0.3 percentage point higher to 4.9 percent.

Venture capital activity declined in the first quarter — inflows were barely one-fifth of the level recorded in late 2004. Attracting more venture funds is a high priority in the state, with legislators recently pushing for the establishment of an Entrepreneurial Investment Technology Tax Credit,

MD Home Sales, Q1:00-Q1:05



NOTE: Shaded Area Represents Recessionary Period
SOURCE: Sales of Existing Housing Units, National Association of Realtors®

which early-stage investors could then apply toward their state income or insurance premium tax bill.

Maryland's residential real estate market advanced at a moderate pace in early 2005. New permit growth was robust, but sales of existing housing units backed off 10.1 percent in the first quarter. Even so, demand for housing remained strong enough to boost prices by 15.9 percent in the first quarter, the largest quarterly jump recorded districtwide.

North Carolina

Economic conditions in North Carolina blew hot and cold in the first quarter. Sluggishness persisted in state labor markets into early 2005, though indicators of business investment and real estate conditions continued to firm.

First-quarter employment activity was generally flat in North Carolina, with job losses outnumbering gains by only 200. Manufacturing and natural resources and mining establishments trimmed payrolls, as they had the previous quarter. Services companies also cut payrolls, with losses recorded in most industry sectors.

Reflecting lackluster payroll activity, North Carolina's jobless rate was little changed in the first quarter. The share of unemployed persons inched down 0.1 percentage point to 5.2 percent. Other measures of the labor market were less encouraging. Initial unemployment insurance claims, which are often viewed as a signal of future labor market activity, rose 7.1 percent in the first quarter — designating North Carolina as the only District state to record an increase in this measure. News from the job front was similar in some of North Carolina's largest metro areas, with first-quarter payrolls in Charlotte and Raleigh contracting 4 percent and 3.8 percent, respectively.

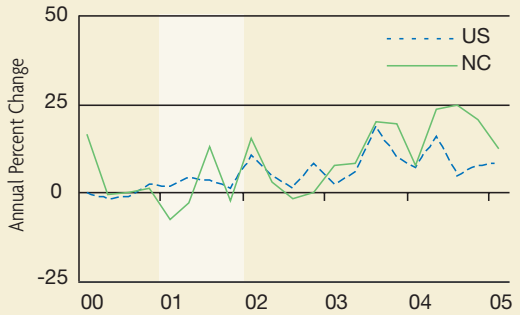
> Economic conditions in North Carolina blew hot and cold in the first quarter.

North Carolina has launched a number of programs in recent years to attract more high-salary jobs, one of the more recent of which is the proposed Defense Technology Innovation Center near Fort Bragg. The business incubator would assist North Carolina companies targeting government defense contracts.

The latest indicators of business activity in North Carolina were more encouraging, with venture capital investment coming in just shy of $100 million in the first quarter. Although the first-quarter reading fell slightly short of late 2004 measures, North Carolina attracted the bulk of funding districtwide — accounting for more than 40 percent of total inflows.

Looking next at the residential real estate market, the most recent data suggest that the sector continued to firm. The number of first-quarter building permits issued in North Carolina exceeded the number authorized a quarter earlier by 39.8 percent.

NC Home Sales, Q1:00-Q1:05



NOTE: Shaded Area Represents Recessionary Period
SOURCE: Sales of Existing Housing Units, National Association of Realtors®

Existing home sales also forged ahead, expanding 21.8 percent in the first quarter — the strongest increase districtwide. Continued demand has boosted the price of the state's housing stock, but at a more tempered pace than seen in other areas. Home prices rose by 7.4 percent in the first quarter, far less than the districtwide rate increase of 11 percent.

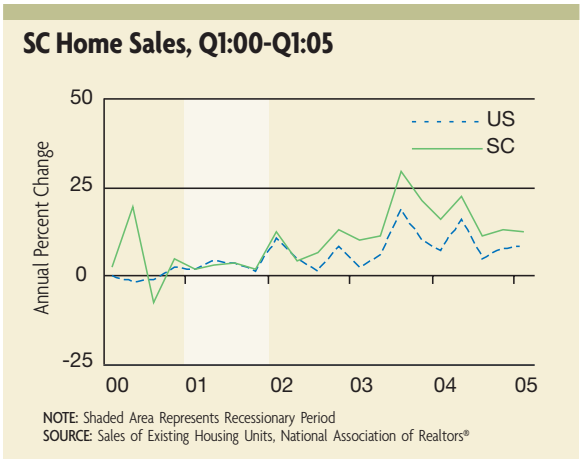
South Carolina

The economic upturn has advanced more slowly in South Carolina than in other District states, with improvement in the state's labor markets slow to take hold. The latest data suggest that employment and venture capital investment remain below their historical highs, though South Carolina's residential real estate market — buoyed by relatively moderate price increases — remained robust.

South Carolina payrolls declined an additional 0.2 percent in the first quarter, marking the third straight quarter of job losses. By sector, jobs were trimmed at all establishment types except trade, transportation, and utilities, leisure and hospitality, information, and construction. The weak job market was also reflected in South Carolina's unemployment rate, which edged up slightly to 7 percent in the first quarter.

Employment data from South Carolina's major metro areas told a similar story. Payrolls edged lower in Charleston and Columbia in the first quarter, falling 2.8 percent and 3.6 percent, respectively. The jobless rate also kicked up sharply in both areas – jumping from 4.6 percent to 6 percent in Charleston and 5 percent to 6.6 percent in Columbia.

News was also lackluster on the state's business front. Venture capital funding was generally flat in the first quarter,



totaling a modest $200,000, a significant decrease from the $13.3 million attracted a quarter earlier. Enhancing the skills of South Carolina's workforce would make the state more attractive to outside investors. Moving in this direction, Claflin University in Orangeburg was one of 12 colleges nationwide selected to receive $750,000 in federal funding earmarked to prepare students for biotechnology jobs. Further, the U.S. Labor Department reported that surrounding high schools would eventually have biotech lessons incorporated into their curriculum as part of a long-term training program.

For now, though, the best news continued to come from South Carolina's residential real estate market. First-quarter permit authorizations expanded briskly compared to early 2004, with South Carolina posting the second strongest pick-up districtwide. Likewise, existing home sales came in above year-ago levels, although they moderated somewhat from the fourth-quarter level. The slight abatement in sales, however, was less pronounced than in most other District jurisdictions. Home prices in South Carolina moved up only 7 percent in the first quarter — the second slowest growth districtwide.

Virginia

The most recent measures of Virginia's economy were generally upbeat. Employment and investment activity continued to firm, while residential real estate activity remained steady, despite rising home prices.

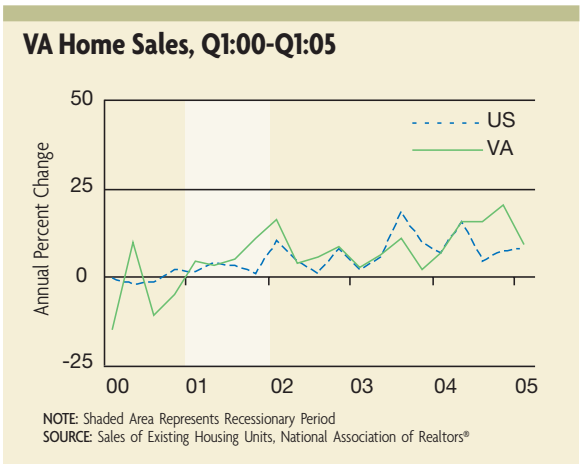
Virginia firms boosted payrolls by 1 percent the first three months of 2005, and unemployment insurance claims retreated 0.6 percent. Jobs were added in all sectors except natural resources and mining, manufacturing, leisure and hospitality, and government. The jobless rate reflected the pickup in hiring at businesses, dropping 0.3 percentage point to 3.3 percent — the lowest unemployment rate districtwide.

The state's labor market is affected by military presence, ranking second only to California in defense employment and spending in 2003. As such, upcoming decisions from the Base Realignment and Closure Commission are of particular import — especially around the Norfolk metro area, which is home to nearly half of Virginia's military bases. In the first quarter, employment news from the Norfolk MSA wasn't as bright as reported statewide. Payrolls were trimmed 7.4 percent from late 2004, though they remained 1.7 percent higher over the year.

In state business conditions, recent reports were mostly favorable. According to first-quarter data, Virginia saw an increase in venture capital inflows — bucking a districtwide and national downturn. The first-quarter expansion in funding marked the second straight quarterly gain for the state, following three periods of decline.

> Residential real estate activity in Virginia remained steady, despite rising home prices.

Virginia's residential real estate market powered forward in early 2005. Compared to year-ago levels, new building permit authorizations rolled in at a slightly slower pace but first-quarter existing home sales were up 9.4 percent. Viewed against data from the fourth quarter of 2004, however, the pace of residential sales moderated — due partly perhaps to the sharp acceleration in Virginia home prices. In the first quarter alone, prices shot up by 15.2 percent, bringing the four-quarter growth rate to 18.6 percent — the 8th strongest increase nationwide.



West Virginia

First-quarter economic data suggest that West Virginia's economy continued to improve in early 2005. Although indicators of financial conditions at state businesses

remained mixed, real estate and jobs activity were mostly positive across the board.

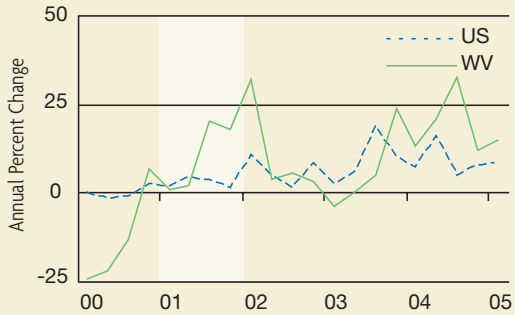
Payroll employment rose 1.5 percent in West Virginia during the first quarter of 2005, marking six quarters of positive job growth. Gains were reported in the majority of industry sectors — even manufacturers tacked on a few more jobs in early 2005 — but weakness persisted in natural resources and mining, information, financial activities, and education and health services. By comparison, news from the job front was not as bright in the Charleston metro area – first-quarter payrolls contracted 4.7 percent, and the jobless rate shot up 1.5 percentage points to 5.9 percent.

The pickup in hiring was not fully reflected in other first-quarter labor market indicators. West Virginia's jobless rate was unchanged in early 2005, holding fast at 5 percent. Further, initial unemployment insurance claims only retreated 0.1 percent in the first quarter, far less than the 5.4 percent decline seen nationally. Looking back over the year, however, improvement in these measures was more apparent — claims moved 12.8 percent lower and the jobless rate declined by 0.4 percentage point.

Recent employment and income gains have broadened home affordability in the state. According to recently released data by the Census Bureau, West Virginia had the lowest median home price nationwide in 2003 ($78,201) just over half the national median price. Home prices in the state have risen steadily since then, but at a slower pace than recorded in other District states. For instance, first-quarter home prices kicked up only 4.3 percent in West Virginia, marking the slowest acceleration districtwide. West Virginians have taken advantage of the relative affordability of the state's housing stock, as reflected by the sustained volume in residential sales and building permits. Compared to a year ago, existing home sales in West Virginia stood 14.9 percent higher in the first quarter, and permit authorizations were up 6.5 percent.

Other recent indicators of business activity in West Virginia were less encouraging. First-quarter venture capital inflows were flat — following a surge of $5.3 million in late 2004.

WV Home Sales, Q1:00-Q1:05



NOTE: Shaded Area Represents Recessionary Period
SOURCE: Sales of Existing Housing Units, National Association of Realtors®

Behind the Numbers: Housing Bubble?

Economists disagree about both the definition of and the existence of a U.S. housing bubble. Deutsche Bank strategist Peter Garber says it's nearly impossible to identify a true bubble, while Yale economist Robert Shiller, author of *Irrational Exuberance*, offers this description: "a situation in which temporarily high prices are sustained largely by investors' enthusiasm rather than by consistent estimation of real value."

But how to gauge if prices are temporarily high? Among the traditional measures are the housing price index (HPI) and the price-to-rent ratio. In a recent study, the Federal Deposit Insurance Corporation (FDIC) looked at the HPI and said the number of "boom" markets grew by 72 percent last year, now encompassing 55 metropolitan areas, including five in the Fifth District. Nationally, the price-to-rent ratio grew by nearly 30 percent in the past five years. The FDIC notes that a housing boom seldom leads to a housing bust — which ought to give some reassurance to homeowners in the Washington, D.C., metro area, whose housing prices nearly doubled over the past five years. — Doug Campbell

Top-Five Fifth District Markets in Home Price Appreciation Through Q1:05

Metro Area	Rank*	One-Year	Five-Year
Washington, DC	27	23.14	93.65
Baltimore, MD	45	20.96	76.04
Hagerstown, MD	58	20.19	68.20
Va. Beach-Norfolk, VA	59	22.12	67.56
Charlottesville, VA	63	17.23	64.51
Others			
Yuba City, CA	1	26.03	121.96
Los Angeles, CA	16	25.55	105.52
New York, NY	44	15.57	76.55
San Francisco, CA	66	17.50	62.88
Chicago, IL	95	10.57	45.10
Atlanta, GA	145	4.86	29.07

*Ranked by five-year change among 265 metro areas
SOURCE: Office of Federal Housing Enterprise Oversight

State Data, Q1:05

	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000)	674.9	2,546.3	3,850.0	1,820.0	3,629.8	740.7
Q/Q Percent Change	1.1	1.8	0.0	-0.2	1.0	1.5
Y/Y Percent Change	0.6	1.6	1.3	0.1	2.4	1.0
Manufacturing Employment (000)	2.4	140.4	575.6	265.2	298.4	62.7
Q/Q Percent Change	-10.4	-5.1	-2.8	-5.1	-2.0	0.2
Y/Y Percent Change	-2.7	-1.9	-0.3	-0.8	0.0	-1.1
Professional/Business Services Employment (000)	143.1	380.7	434.7	183.2	591.5	58.0
Q/Q Percent Change	0.1	3.7	-1.8	-14.7	2.0	0.5
Y/Y Percent Change	0.8	3.0	2.6	-2.6	4.9	-0.7
Government Employment (000)	230.7	462.0	650.7	329.7	654.4	143.1
Q/Q Percent Change	-0.6	0.7	0.5	-1.8	-0.4	0.7
Y/Y Percent Change	0.0	-0.8	0.7	1.8	1.3	0.3
Civilian Labor Force (000)	305.1	2,896.4	4,283.7	2,073.0	3,855.3	792.2
Q/Q Percent Change	5.1	1.5	1.9	2.5	2.5	3.3
Y/Y Percent Change	2.1	0.6	0.9	2.0	1.6	0.3
Unemployment Rate (%)	8.0	4.2	5.2	7.0	3.3	5.0
Q4:04	8.7	4.2	5.3	6.9	3.6	5.0
Q1:04	7.6	4.2	5.8	6.7	3.7	5.4
Personal Income ($bil)	27.4	209.7	239.7	108.5	255.3	44.9
Q/Q Percent Change	0.8	0.7	0.6	0.2	0.7	1.1
Y/Y Percent Change	4.1	4.6	4.9	4.0	5.5	4.6
Building Permits	565	7,745	22,161	12,650	13,460	1,336
Q/Q Percent Change	602.9	33.1	39.8	97.0	-6.0	132.4
Y/Y Percent Change	269.3	31.8	-0.8	33.5	-9.9	6.5
House Price Index (1980=100)	511.5	421.2	294.2	275.8	385.2	216.8
Q/Q Percent Change	11.3	15.9	7.4	7.0	15.2	4.3
Y/Y Percent Change	22.2	21.0	6.0	6.9	18.6	7.8
Sales of Existing Housing Units (000)	14.4	130.2	213.5	102.5	183.5	34.7
Q/Q Percent Change	-10.0	-10.1	21.8	-1.6	-6.3	-29.8
Y/Y Percent Change	0.7	-1.1	12.7	12.3	9.4	14.9

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics, Manufacturing, thousands of jobs, SA; BLS/Haver Analytics, Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics Government, thousands of jobs, SA; BLS/Haver Analytics, Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics, Unemployment Rate, percent, SA; BLS/Haver Analytics, Personal Income, billions of chained 2000$, Bureau of Economic Analysis/Haver Analytics, Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics, House Price Index, 1980=100, NSA, Office of Federal Housing Enterprise Oversight/Haver Analytics, Sales of Existing Housing Units, thousands of units, SA; National Association of Realtors®

Metropolitan Area Data, Q1:05

	Washington, DC MSA	Baltimore, MD MSA	Charlotte, NC MSA
Nonfarm Employment (000)	2,869.4	1,249.4	783.2
Q/Q Percent Change	-2.9	-7.6	-4.0
Y/Y Percent Change	2.8	0.7	3.2
Unemployment Rate (%)	3.7	4.9	5.4
Q4:04	3.2	4.6	5.6
Q1:04	3.4	5.0	6.5
Building Permits	8,304	2,100	4,734
Q/Q Percent Change	24.2	-71.9	8.2
Y/Y Percent Change	0.5	8.2	-5.1

	Raleigh, NC MSA	Charleston, SC MSA	Columbia, SC MSA
Nonfarm Employment (000)	266.1	274.1	343.5
Q/Q Percent Change	-3.8	-2.8	-3.6
Y/Y Percent Change	1.3	3.2	1.5
Unemployment Rate (%)	4.1	6.0	6.6
Q4:04	3.5	4.6	5.0
Q1:04	4.0	4.5	4.8
Building Permits	3,139	2,522	1,810
Q/Q Percent Change	5.3	125.1	45.2
Y/Y Percent Change	-16.9	51.8	10.0

	Norfolk, VA MSA	Richmond, VA MSA	Charleston, WV MSA
Nonfarm Employment (000)	744.0	606.6	147.2
Q/Q Percent Change	-7.4	-2.1	-4.7
Y/Y Percent Change	1.7	2.2	0.6
Unemployment Rate (%)	4.1	3.8	5.9
Q4:04	4.4	4.0	4.4
Q2:04	4.6	4.3	5.2
Building Permits	2,427	2,820	68
Q/Q Percent Change	-26.5	209.0	0.0
Y/Y Percent Change	-1.5	30.0	-18.1

For more information, contact Andrea Holland at 804-697-8273 or e-mail Andrea.Holland@rich.frb.org.

OPINION

The Economics of Bankruptcy

BY KARTIK ATHREYA

Few people seriously challenge the idea that there should be some form of personal bankruptcy protection. In most circles it's taken for granted that the availability of an option allowing people to erase their debts is a proper response to the hazards of modern-day financial life. The elderly get sick and can't pay their medical bills. Young mothers get divorced and are awarded sole custody of their children — and then they lose their jobs. Bankruptcy is the ultimate safety net.

Reforms signed into law this spring by President Bush make it harder for individuals to walk away from their debts. But the new rules don't address this basic question: From an economic perspective, is bankruptcy protection — even after the latest overhaul — really sensible?

The answer is not perfectly straightforward. But recent research, including some of my own, leads me to be skeptical about what economists call the "welfare-improving" virtues of bankruptcy, particularly for non-entrepreneurs. By that I mean the wider costs of maintaining the personal bankruptcy system appear to outstrip the benefits.

At its heart, personal bankruptcy is an insurance program. It aims to provide a backstop against financial misfortune for which there exist few private-sector alternatives. Drivers can be insured against accidents because it's relatively easy for insurers to assess the level of risk each driver represents. But it's not as easy to size up a person's financial risk. How hard an unemployed person is looking for new work, for example, is tricky for an outsider to gauge. So instead of private insurance, we have opted for a de facto government-mandated insurance program in bankruptcy protection.

> From an economic perspective, is bankruptcy protection — even after the latest overhaul — really sensible?

The problem with this system is that it raises costs for everybody. In particular, it raises the cost of unsecured credit — chiefly, credit cards and bills for medical care — for the people who most need it, young people and poor people, both of whom usually lack collateral.

The law says that people have a right to avoid unsecured debts by seeking bankruptcy protection. Creditors know that everybody they lend to has this option. It's expensive to borrow in this kind of world because lenders must charge extra for the very real possibility that they won't be able to fully collect. In effect, bankruptcy law disables those who possess few assets from making commitments to fully repay debts.

Why do we foist this "protection" on all households? If we lived in a society that allowed borrowing but forbade defaulting under any circumstances (an admittedly extreme and unrealistic scenario) it would become significantly cheaper to borrow. In the models I've looked at, the gains accruing per U.S. household would be equivalent to as much as $280 a year. These gains encompass everything from cheaper borrowing costs to eliminating after-the-fact punishments like stigma.

Another way to see this is to consider the difference between borrowing on a home equity line versus a credit card. The roughly 10 percent wedge in interest rates between home equity lines, which are backed by the collateral of property, and credit cards, which are unsecured, is a striking indicator of the value of a credible commitment to repay debts. On a loan of $10,000, this "credibility gap" may cost unsecured borrowers $1,000 more annually than their collateralized counterparts.

Given the large costs bankruptcy law imposes on households, especially poor ones, there is too much at stake to allow policy to be guided by the current, somewhat hysterical debate. What I want is a policy debate that relies less on emotionally charged stories about tragically unlucky filers or wealthy abusers of the system. We must focus more on a careful and hard-headed accounting of bankruptcy's actual costs and benefits.

Roughly 1 million U.S. households filed for Chapter 7 bankruptcy protection last year. Tougher bankruptcy eligibility rules than those that have been presented so far would improve the terms and availability of credit for all Americans. In particular, such rules would benefit the 60 million people between the ages of 20 and 35 who today face the highest costs in obtaining unsecured credit.

In a world of competing and evolving insurance programs, does personal bankruptcy still serve us well? Among economists addressing these questions, there is an emerging consensus against bankruptcy as it's currently practiced. But this conclusion leaves the door open for some extreme cases — sudden medical setbacks in particular. More generally, we should think harder about other ways to help people facing catastrophic health events.

That may be just another way of saying that I believe we should offer some form of bankruptcy, albeit with strings attached. Means-testing, while piecemeal, seems like a small step in the right direction. The more fundamental task of understanding bankruptcy's redistributive- and incentive-related implications remains squarely in front of both lawmakers and researchers. **RF**

Next Issue

Smart Start

Early childhood education programs have become a top priority for many policymakers, including some who believe they are a promising economic development strategy. Such programs, officials say, help kids acquire skills that they can build upon throughout their lives, resulting ultimately in a well-trained workforce. We'll take a look at North Carolina's "Smart Start" initiative and see how this program has fared since its inception in 1993.

Are Entrepreneurs Born or Made?

Entrepreneurial activity is key to our nation's dynamic economy. But can it be taught? Some think so. For instance, students at Western Carolina University's School of Business can major in entrepreneurship. We'll speak with analysts who have studied the topic, as well as with entrepreneurs themselves.

Why Do Economists and the Public So Frequently Disagree?

Most economists favor free trade, but many people think that globalization is harmful. Similarly, economists generally advocate incentive-based approaches to regulation, while the public often supports direct controls. How large is the gap between the way economists and the general public think about policy issues? And why do the differences exist?

Eminent Domain

The Supreme Court recently issued a decision that makes it easier for government to seize private property for public use. What is the economic justification for "eminent domain" measures, and do recent public-directed development projects satisfy that threshold?

Economic History

The Civil War was hugely expensive — both in human and dollar terms. The Union and the Confederacy employed significantly different methods to finance the war. We'll examine the monetary policies of the North and the South, and consider how the Civil War ushered in lasting changes to the nation's financial system.

Interview

A conversation with Robert Moffitt, a labor economist at Johns Hopkins University and editor of the *American Economic Review*.

Research Spotlight

What can we learn about economics by looking at people's brain activity? A survey of the growing "neuroeconomics" literature.

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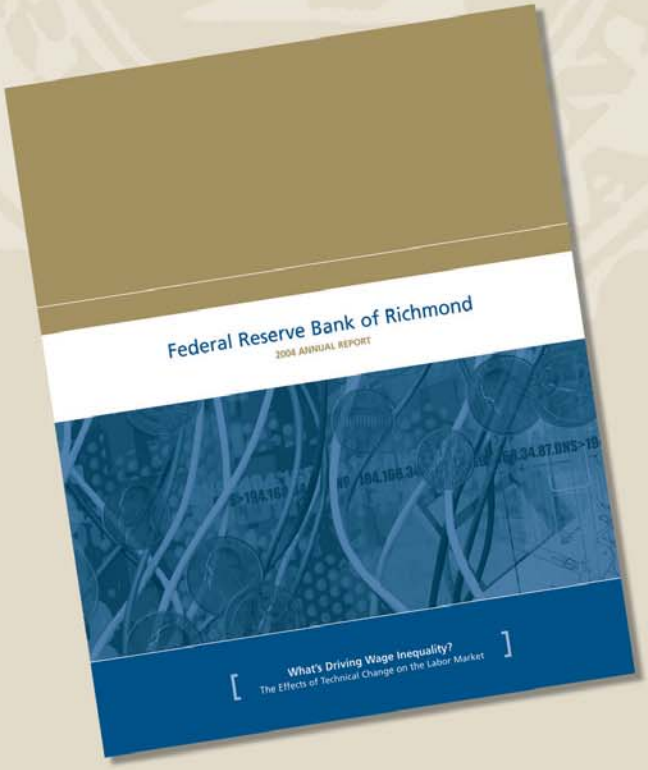
The Fall 2005 issue will be published in October.

The Economic Forces Behind Wage Inequality

The gap in real wage rates between those at the higher end of the income distribution and those at the lower end has been widening for about 30 years. Some have attributed this growth in wage inequality to globalization. But there is another important force affecting America's labor markets — technical innovation.



In the Federal Reserve Bank of Richmond's *2004 Annual Report* feature article, "What's Driving Wage Inequality? The Effects of Technical Change on the Labor Market," the Bank's Director of Research and the editor of *Region Focus* argue that advancements in technology, particularly information technology, have boosted the productivity of skilled labor relative to that of unskilled labor. Such "skill-biased technical change" has led to greater wage dispersion, they contend. The authors maintain that efforts to slow international trade likely would have little effect on wage patterns, while reducing overall welfare, and suggest that a more promising policy response would be to increase emphasis on early childhood education and broadly applicable skills.

The *Annual Report* also includes messages from the president and management, in which they discuss the economy and Bank operations, and an overview of the Richmond Fed's 2004 financial activity.

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