

WINTER 2009

REGION FOCUS

THE FEDERAL RESERVE BANK OF RICHMOND

CORPORATE

BANKRUPTCY

ВАНКВАНЬТСА

REGION FOCUS

COVER STORY

14

Know When to Fold 'Em: How the corporate bankruptcy system benefits and hinders the economy

It's important to distinguish between firms that are merely distressed and those that are no longer viable. Does the current corporate bankruptcy system provide the most efficient means to this end?

FEATURES

18

The Language of Local: Community papers survive by sweating the small stuff

While many big metro dailies are floundering, community newspapers seem to be weathering the storm.

22

Science Panel May Study Virginia Uranium Plan

Uranium found in Virginia's rural Pittsylvania County opens up a new front in the national debate over the future of nuclear energy.

24

Ballpark Boom: New minor league stadiums spring up across the region

Since 2005, four minor league baseball parks have been built in the Fifth District. Are they really engines of economic growth?

28

Learning Curves: The economics behind high school economic education

Standards for how Fifth District students learn about supply and demand have been established. But a debate remains about the effectiveness of economic education and personal finance programs.

33

Housing Cools State-to-State Migration: But Carolinas remain a magnet

People aren't moving as much these days. But that hasn't stopped the Carolinas from ranking among the fastest-growing states in the United States last year.

36

The Banking Landscape in the Fifth District

A look at the size and scope of the region's depository institutions.

DEPARTMENTS

1 President's Message/Time to Rethink "Too Big To Fail"

2 Upfront/Economic News Across the Region

6 Federal Reserve/Last Stop Lending

10 Jargon Alert/National Debt

11 Research Spotlight/Does Democracy Lead to Economic Growth?

12 Policy Update/States Receive Funding from Stimulus Bill

13 Around the Fed/How Consumers Use Plastic — and Why

38 Interview/George Selgin

43 Economic History/West Virginia Glass Houses

47 Book Review/When Altruism Isn't Enough

48 District Digest/Economic Trends Across the Region

56 Opinion/No Time for Protectionist Impulses

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CORPORATE
BANKRUPTCY

Time to Rethink “Too Big To Fail”



The cover story of this issue of *Region Focus* discusses the U.S. corporate bankruptcy system. The article points out some of the strengths and weaknesses of that system, from the standpoint of economic efficiency. The system is not perfect. For instance, firms that are no longer economically viable may be able to find sympathetic judges who postpone liquidation beyond a period that would be optimal for the economy as a whole. It would be better, in some of those cases, to expedite the liquidation, freeing up valuable resources that could be more effectively used elsewhere.

But, in the main, the corporate bankruptcy system, which has evolved over many decades, works relatively well. It provides an opportunity for fundamentally sound companies that are experiencing temporary difficulties to reorganize and get back on their feet. And it includes measures that guide the orderly closing of firms which cannot effectively compete in their respective markets.

An example of such a firm, which the article discusses in some detail, is the electronics retailer Circuit City, based here in Richmond. It operated in an extremely competitive environment in which consumers are highly discriminating. Ultimately, enough of those consumers opted to shop with Circuit City's competitors that the firm could not survive. For many of the former employees of Circuit City, this is no doubt painful. The change that results from competition is not always pleasant, but it is essential to the functioning of a healthy market economy.

For most sectors of the economy, policymakers recognize that there should and will be frequent change, including the failure of some firms. And the corporate bankruptcy system helps to facilitate those closures in a way that is generally beneficial to the economy.

There are, however, a few exceptions: sectors that many policymakers believe include firms which simply cannot be allowed to fail. The most obvious example is the financial sector. Financial institutions are, of course, crucial to a market system. They provide the liquidity needed by businesses across the economy. But because of their unique function in the economy, should they be protected from failure?

That is a difficult question. It is possible that the failure of a particularly large firm could cause great harm to the economy. But first we should ask why so many big financial institutions came under enormous stress over the past year.

There are several reasons, to be sure, but a significant factor was that many of them believed they were “too big to fail” — that is, they were willing to take excessive risks because they were confident they enjoyed either explicit or implicit public support. And, of course, such support has been forthcoming in numerous cases.

As a result, some people have called for the creation of a systemic risk regulator to oversee all financial institutions. Ultimately, such a regulator could prove useful, though I am generally skeptical of the idea. One thing seems clear, however. Redesigning our financial regulatory system before establishing clear boundaries around the federal financial safety net — boundaries that I believe should be much tighter than at present — would be like putting the cart before the horse.

The financial crisis should lead us to think hard about the incentives that financial institutions face — and what we can do to reform them to bring greater stability to the system, while at the same time not discouraging innovation. At the top of the list is rethinking whether “too big to fail” protections move us toward that goal or away from it.

A handwritten signature in black ink, appearing to read 'Jeff M Lacker'. The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND

Silver Screen

Cinemas Prosper During Recession

Bow Tie Cinemas opened a 17-screen movie theater in Richmond, Va., in February. The multiplex, named Movieland at Boulevard Square, is the largest the company has ever opened.

While declining to provide specific ticket sales numbers, Bow Tie Chief Operating Officer Joe Masher said the Richmond multiplex had a “phenomenal” opening weekend. In part, that’s because people seem to like going to the movies during recessions. For many, it’s seen as a relatively cheap form of entertainment.

According to Patrick Corcoran, the director of media and research for the National Association of Theater Owners, from Jan. 1 through March 2, 2009, national box office receipts were 13.1 percent higher than the same period in 2007, when the economy was still growing. And from the third week of September 2008, when the stock market became volatile and the credit crisis a national discussion, through the second week of December 2008, receipts rose 15 percent over the same period in 2007.

Business is up at Regal Cinemas, according to Chad Browning, marketing manager with Regal Entertainment

Group, based in Knoxville, Tenn. The chain owns 30 theaters in Virginia, 24 in North Carolina, 16 in South Carolina, and 15 in Maryland. “I think people just kind of want to escape from the sluggish economy,” he said.

Movies are also making more money this year. Many moviegoers have found respite through stories of a dim-witted mall security guard and of a father trying to rescue his kidnapped daughter. “Paul Blart: Mall Cop” and “Taken,” released in 2009, have each grossed more than \$100 million. “Gran Torino,” a drama starring Clint Eastwood, released in late 2008, has made more than \$100 million in 2009 alone, Corcoran said. From January through May of 2008, only one film grossed more than \$100 million.

In choosing where to open theaters, Bow Tie looks for communities with active arts, medical, and educational communities. “Richmond was a perfect storm for all three,” Masher said. Bow Tie’s Richmond multiplex is the company’s third in the Fifth District, joining two in Annapolis, Md.

Bow Tie isn’t the only company bringing a new theater to Richmond in 2009. Regal opened the Westchester Commons Stadium 16 in suburban Midlothian this spring. That multiplex comes online just before studios start releasing their summer blockbuster films, including “Harry Potter and the Half Blood Prince,” among others. “We’re hoping for big grosses out of those films,” Browning said.

While box office numbers are on the rise in 2009, DVD sales have fallen off, Corcoran said. Those revenues had started to plateau before the economic slump. People have “very full libraries” of DVDs and are no longer looking to add to them.

—DAVID VAN DEN BERG



From blockbusters to classic films to screenings of cult movies ... you'll see them all at Movieland.

PHOTOGRAPHY: COURTESY OF BOW TIE CINEMAS

Smoking Bans

Smoke-Free Mandates Come to Tobacco Country

Starting December 1, Virginia will ban smoking in both bars and restaurants.

The only exceptions to Virginia's ban will be private clubs as well as restaurants and bars that have separately ventilated smoking rooms. Outdoor smoking on patios will be allowed. And employers won't be allowed to require their staff to work in smoking areas.

Lately, smoking bans have tended to come with no exemptions, says Michael Pakko, an economist with the Federal Reserve Bank of St. Louis. The exemptions should help reduce the losses that Virginia businesses will experience from the ban, he says.

At press time, the North Carolina Legislature was also debating a smoking ban. The House has passed a bill that bans smoking in restaurants, but allows it in private clubs and businesses that ban minors. A House committee had passed a more comprehensive smoking ban that prohibited smoking in restaurants, bars, and most public places, according to the *Asheville Citizen-Times*.

Virginia and North Carolina, where tobacco is a major part of the history and economy of each state, would join Maryland and the District of Columbia in banning smoking in bars and restaurants around the Fifth District. West Virginia and South Carolina do not have statewide bans, although certain cities and counties in South Carolina ban smoking. The cities of Charleston, Columbia, and Greenville have bans.

Critics of smoking bans suggest that restaurants and bars already have an incentive to cater to consumer demand — including demand for smoke-free establishments.

Also, smoking bans could have some unintended consequences. Economists Chad Cotti of the University of Wisconsin-Oshkosh and Scott Adams of the University of Wisconsin-Milwaukee found a higher number of fatal traffic accidents involving alcohol in locations where smoking is banned in bars compared to locations where smoking in bars is allowed. That's because the bans provide an incentive for smokers to drive longer distances to — and from — where they can smoke in bars. In a different paper, they also found smoking bans reduce employment by a statistically significant amount at bars, but have a neutral effect on restaurant employment, on average. States with a larger number of smokers see more negative effects, but as the number of smokers continues to drop, these effects will too, Cotti says.

Tax and price increases have played a major role already in reducing the number of smokers. Economists traditionally view tax policy as a way to curb smoking or recover costs from externalities that smoking causes. While there is disagreement about the magnitude of smoking's health care costs, "that there are costs I think is pretty clear," says Frank Chaloupka, a University of Illinois-Chicago economist. While taxation is a "blunt instrument," he says, tax increases can have a significant impact on the smoking habits of young people, who tend to be more responsive to price increases than older smokers.

—DAVID VAN DEN BERG

Lights Out

Incentive and Retention Pay OK'd for Circuit City Employees

These days the subject of bonuses to executives of troubled firms incites strong reactions. But are there circumstances in which they are justified?

Maybe so, according to Circuit City. The 60-year-old electronics retailer based in Richmond, Va., filed for Chapter 11 bankruptcy in November 2008 and announced its liquidation in January 2009. Many were surprised when the company appealed to bankruptcy courts in February 2009 for more than \$4 million to provide additional pay to executives and staff

overseeing the liquidation process.

These funds are not bonuses, however, argues Bill Cimino, Circuit City's head of corporate communications. He says the funds are being provided to incentivize executives and retain critical nonexecutives throughout the liquidation process. "They are primarily being used to maximize the value of the 'estate' for Circuit City's unsecured creditors," Cimino says.

Unsecured creditors of a liquidating company can be the biggest losers from bankruptcy, since they are the last of the



Empty parking lots are a common sight at the 567 Circuit City retail locations that closed in the first quarter of 2009 after the company announced its liquidation in January.

PHOTOGRAPH: DAVID VAN DEN BERG

creditors to get paid from the remaining value of the company. The relationship between the payout to unsecured creditors and the orderliness of the liquidation process is clear: The more efficient the liquidation, the greater the remaining value of the estate. That means the unsecured creditors are able to recoup more of what they are owed by the company.

The Circuit City plan works like this: A group of 14 top executives and officers will receive roughly \$2 million through the plan. The pay will be awarded gradually, as executives meet a set of 20 goals relating to the liquidation. The amount they receive will vary according to how successfully the tasks or goals are completed. As a result, the final amount ultimately paid out may be less than the \$4 million approved for the overall retention and incentive plan.

Circuit City estimated that each of the 20 targets would increase the total value of the estate by \$250 million if completed at the maximum success level, while the corresponding cost in executive pay would be less than 1 percent of that amount. "The amount of revenue they bring in determines how much is paid out to them," Cimino says.

The company knew it would be a "hot button" issue to allocate incentive pay to its top executives when 34,000 other staff would lose their jobs as a result of the liquidation. As a result, it agreed to take chief executive officer James Marcum out of the incentive package.

The company also views stopping the drain of essential nonexecutive employees as critical to maximizing the revenue from liquidation. A group of 137 employees at director-level and below will receive up to \$1.62 million in retention pay if they stay with the firm through specified dates. This is in addition to a "discretionary" pool of up to \$750,000 to be distributed to any of 250 employees (top-level executives excluded) to stem any sudden

turnover or to hire anyone with needed skill sets. It would also finance more mundane tasks that are essential to winding down the company's operations.

"People don't realize what has to happen behind the scenes to make a liquidation happen," says Scott Carpenter of Great American Group, one of four companies collaborating in Circuit City's liquidation. "Despite the liquidation, you have to keep systems going, lights on, and heat and water flowing, in addition to more obvious needs like payroll," he says. "Those people who stay on are a critical function."

After some negotiation, the retention and incentive plan was approved by the company's unsecured creditors. Since they get only what's left of the estate after secured and preferential creditors have exhausted their claims, they have strong incentive to contest any expenses that may not be offset by increasing the value of the estate. "Ultimately," Cimino says, "this money belongs to the creditors. They believe the retention and incentive plan is a good investment to keep people motivated, and to achieve the liquidation goals and thus maximize the value to them when the estate is finally settled."

Critics of the plan have argued that the dour job market is incentive enough for someone to stay with the company, but Carpenter disagrees. "In this economy it may be hard to get a new job, but the most competent people typically won't have any problem," he says. Talented employees who know the business are precisely the ones needed most to stay on to meet the goals of Circuit City's liquidation process, according to Carpenter.

Although Circuit City's nationwide retail locations closed several weeks ahead of schedule in March, it could take the company's corporate operations up to 18 months to completely close its doors. Cimino and Carpenter say the court-approved retention and incentive plans had nothing to do with retail stores closing early; it was purely a result of demand for inventory during the company's close-out sales. The success of the remainder of the wind-down process, however, will depend on remaining staff and executives.

—RENEE COURTOIS

eBang

University Auctions a Demolition Trigger

An implosion took down the 11-story Union Carbide headquarters building near the University of Charleston in South Charleston, W.Va., in March, with alumnus Chris Belcher paying \$5,207 for the privilege of activating the demolition on eBay. But Belcher didn't stop there. He donated the privilege to the university's baseball program where he and his brother played in the 1980s on scholarships. In turn, the team raffled off the right to "push the button" at \$10 per ticket, generating about \$5,000 in sales.

"I've been contacting my clients and vendors — it's been a full-time job on top of my full-time job," Belcher said. He is president and owner of Cincinnati, Ohio-based Pinnacle Environmental.

The general fund will receive the original amount Belcher paid on eBay, but the raffle money will go to the baseball program. "Without those scholarships, neither one of us could have afforded to go there," Belcher said. "When I saw what it [the auction] was going to close for, I said, 'I know we can raise more money than this.'"

Dow Chemical, which bought Union Carbide in 2001, donated the 1948 structure to the university in 2006, but the university would like to sell the 6.5-acre site. The university had planned to house classrooms, faculty offices, and living quarters for pharmacy students in the building, but the cost of compliance with the Americans with Disabilities Act, estimated to be as much as \$10 million, was deemed too high.

The building formerly served as regional headquarters for Union Carbide and was considered a symbol of West Virginia's chemical industry. The land is priced at \$3.5 million. The land is flat and easily accessible to the interstate, an attractive combination in the Mountain State. Two firms handled the \$1.6 million demolition project.

—BETTY JOYCE NASH



The University of Charleston auctioned the privilege of setting off the implosion that demolished a building which Dow Chemical donated to the school in 2006. The \$5,207 will go to the university's annual fund. The lot will be sold.

Smart Grid

Digital Devices Will Save Energy

Duke Energy plans to test an energy efficiency program on 100 of its Charlotte, N.C., customers by early summer. It integrates electronic devices such as digital meters and thermostats that can provide details about electricity consumption. Automatic switching for various appliances, heating, and air systems can save energy and money as well as smooth electricity demand. The goal is to reduce consumption without affecting convenience or productivity.

The final program has yet to be determined, but components are likely to include heating, ventilation, and air-conditioning switches that could be programmed to operate for shorter periods of time. "If you aggregate that across millions of customers, that's a huge amount of energy saved," says spokesman Dave Scanzoni. "Long term, where the industry is headed is time-of-day rates, [where you're] charged less if you use electricity off-peak."

Participants will receive \$100 at the start of the pilot and another \$100 if they finish the program. That's in exchange for allowing the smart technology to be installed, completing surveys, and offering feedback for Duke Energy.

The plan was approved in March by the North Carolina Utilities Commission. If it works, the system may be expanded. Duke Energy already has installed 100,000 digital meters across the five states (including

the Carolinas) where the firm operates, including 12,000 in Charlotte alone.

In the Charlotte pilot program, residents can manage energy use online. Or the utility can manage it for them, according to their "personal energy profile," which tracks the times of day that they run air conditioners, heat pumps, water heaters, dryers, ranges, ovens, pool pumps, lights, outlets — you name it.

"Right now, electricity is one price, 24-7," he says. "There's no incentive to use less or use it at different times." If consumer demand could be shifted, he notes, the need to build more plants that handle electricity at peak hours could be alleviated.

To boost development of smart grid technologies, the American Recovery and Reinvestment Act of 2009, better known as the stimulus bill, contains \$4.5 billion to upgrade the grid. Many times that amount will be necessary to overhaul the nation's transmission system. Duke Energy may apply for those grants once the details are finalized. Any grants would be in addition to its commitment to spend \$1 billion on smart grid efforts over five years.

Reduced energy demand is also a relatively inexpensive way to reduce carbon emissions. Cutting carbon will be essential for electricity producers if the nation prices carbon through a tax or cap-and-trade program.

—BETTY JOYCE NASH

PHOTOGRAPHY: COURTESY OF UNIVERSITY OF CHARLESTON

Last Stop Lending

BY STEPHEN SLIVINSKI

How a railroad
bankruptcy helped
form modern
Fed policy

If you walked into the lobby of a Federal Reserve Bank in the early part of the 20th century, you'd see a teller window. If you were a bank manager, walking up to that window would literally allow you to borrow money from the Fed under certain conditions. Eventually, these windows would disappear from Fed lobbies. But their function — the power of the Fed to lend through figurative versions of that window — wouldn't disappear.

This window, called the “discount window,” was originally conceived as the means by which the Federal Reserve would serve as a lender of last resort to its member banks. The idea was to provide an outlet by which the Fed could supply liquidity to banks in the event of a credit-tightening economic shock.

Yet, within that seemingly simple mission is a bundle of implications and policy approaches that are still being debated by economists and policy-makers today. And, as an unpredictable turn of history would have it, the precedent for the modern version of that debate is, at least in part, the bankruptcy of a railroad company in 1970.

The history of the Fed's role here is important to understand first. For this we

have to look back 200 years and across the Atlantic Ocean. The central bank's role as lender of last resort has, as former Richmond Fed economist Thomas Humphrey points out, its first “and in many respects still its most rigorous, complete, and systematic” explanation in the early 19th

century writings of British economist Henry Thornton. When his best-known work on the subject was published in 1802 (*An Enquiry Into the Nature and Effects of the Paper Credit of Great Britain*), he was a member of Parliament with a particular expertise on matters of monetary policy. Not only was his brother one of the directors of the Bank of England, but he was also a member of the various legislative committees that oversaw the operations of the banking system in Great Britain.

In Thornton's conception of an independent central bank's role, the main focus should be the stability of the money supply. An element of that role was the need to serve as a lender to banks in a case of economic shock for the purposes of meeting an increase in demand for money. In what economist Joseph Schumpeter later called the “Magna Carta of central banking,” Thornton outlined the need to make this sort of lending by the central bank temporary in nature and restrained enough not to interfere with the Bank's main goal of price stability. To violate this rule would invite political gaming of monetary policy by interest groups: “To suffer either the solicitations of merchants, or the wishes of government, to determine the measure of the bank issues, is unquestionably to adopt a very false principle of conduct.”

Thornton clearly realized that allowing the central bank to be an emergency lender made it that much more important to remember that its primary responsibility is to the market generally and not to individual banks. Indeed, he was quite concerned about the “moral hazard” that such a lending arrangement might produce in the form of risky practices at individual banks. Thornton's view was that the



In the early years of the Federal Reserve, bankers could literally walk up to the discount window in the lobby of their regional Fed bank to borrow funds.

lender of last resort should not try to prevent economic shocks. Instead, the central bank should aim to neutralize the secondary repercussions of those shocks.

Roughly 70 years later, Thornton's intuition was elaborated by Walter Bagehot, the British writer and editor-in-chief of the *Economist* from 1861 to 1877. In doing so, he advanced Thornton's analysis and set up the framework that economists still use today to discuss these issues.

In his famous book, *Lombard Street* (1873), Bagehot laid out the broad rules by which the lender of last resort role would best function, summed up by the dictum, "lend freely at a high rate, on good collateral." The penalty interest rate would encourage not just the speedy repayment of the debt but also would encourage banks to look for private financing before resorting to the central bank loan as a true last resort. The collateral requirement would help weed out those banks that were not just facing a temporary liquidity crunch but were indeed insolvent.

It was also important that the emergency lending policy be announced in advance of the economic shock so there would be certainty in the market about the backstop measures the central bank would be willing to take. Like Thornton, however, Bagehot was concerned about political pressures on central banks and the temptation to lend to specific institutions as a means to prop them up in an economic crisis. As Humphrey explains, "the job of the central bank is not to prevent failure at all costs but rather to confine the impact of such failure to the unsound institutions."

The Early Federal Reserve and the Rise of Crisis Lending

Such was the thinking of some economists when the Federal Reserve was created. The men who constructed the U.S. central banking system indeed looked at the British experience for guidance on how best to approach the conduct of monetary institutions and how these institutions should be designed.

They envisioned the Fed's role of banker to the banks as being decentralized. The 12 regional Fed banks would allow the banks in their area to borrow reserve funds against the security of their business loans, an act known as "rediscounting." Presumably this sort of operation would best be handled by a bank closest to the borrowers where the local knowledge of business conditions could best be utilized. Indeed, specialized knowledge of local conditions was especially important in an economy where, in certain areas, credit demand was heavily influenced by the seasonal nature of agriculture. In this way, the demand for money in the economy as a whole could be satisfied at a dozen "discount windows." (In a world before modern open market opera-

**Thornton realized
that the central bank's
primary responsibility
is to the market generally
and not to
individual banks.**

tions of buying and selling Treasury bills were the preferred tools of monetary policy, the discount window was an important mechanism in controlling the money supply.)

But the Thornton-Bagehot synthesis would soon meet the political realities of hard economic times. On the heels of the national bank crisis of the early 1930s, Congress passed an amendment to the Federal Reserve Act which was approved by President

Franklin Roosevelt on June 19, 1934. It added a new section — 13(b) — that removed most of the conditions constraining the Fed's ability to lend in a crisis. It essentially authorized the Fed to extend credit to nonbank business enterprises directly for up to five years without any limitations as to the type of asset that could be offered as collateral and without limits on any single loan.

Originally, Fed lending was targeted toward banks that would then lend to distressed businesses. Now the Fed could provide working capital directly to established businesses. The genesis of this role was a 1932 amendment to paragraph 3 of section 13 that allowed the Fed to award loans to nonbanks in "unusual and exigent circumstances."

In the first year after the creation of section 13(b), Fed lending spiked. It became less popular over time because the federal government's Reconstruction Finance Corporation was a much more generous lender.

The Fed's role as banker to a variety of industries continued until the 1950s. Fed policymakers, however, were beginning to sour a bit on their new role by then. In 1951, a bill to further the ability of the Fed to lend to nonbank businesses was not supported by the Fed's Board of Governors because of their concerns about the inflationary impact of expanded lending. Chairman William McChesney Martin's public statement in opposition to an expanded lending role for the Fed helped repeal section 13(b) in 1958. But thanks to the still-intact paragraph 3, the ability to lend to nonbanks in "unusual and exigent circumstances" remained as long as five members of the Board of Governors concurred with the decision to provide such liquidity.

The Penn Central Bankruptcy

Despite this, some critics argue that the assumptions of the Fed as a crisis lender to all sorts of businesses would thereafter be baked into the market's expectations. And there were indeed other changes to federal law that kept the Fed in the lending game after 1958. Of particular note is the Defense Production Act's "v-loans" program, a carryover from World War II and utilized during the Korean War, in which the Federal Reserve served as guarantor of defense production loans made by the federal government. Keeping the possibility of lending to nonbank industries temporarily

open in this way would, in 1970, converge with a recession and a potentially disruptive corporate bankruptcy that would nudge the Fed into a return to its Depression-era role.

Many firms fell on hard times in the recession of 1969-1970, but one of the biggest was the Penn Central railroad. The company had issued a substantial amount of debt, or “commercial paper,” more than \$84 million in outstanding debt at the time, much of which was coming due between June and August of 1970. The firm appealed to the Nixon administration for a loan in May 1970, claiming it could not survive without federal support.

The White House was sympathetic and proposed to a syndicate of about 70 banks a federal guarantee for a \$200 million, two-year loan. The administration proposed to Congress that the loan guarantee would fit under the umbrella of the v-loan program. The implication of the White House seemed to be that keeping Penn Central alive was vital to national security interests even though the company had no explicitly defense-related business.

On Friday, June 19, after six weeks of debate, Congress refused to approve the loan guarantee. On the heels of that defeat, the Nixon administration asked the Federal Reserve Board to authorize the New York Fed to lend directly to Penn Central. After it ran through its procedures to determine the firm’s creditworthiness, the New York Fed reported back to the Board that Penn Central would likely not be able to repay any credit it received. That’s when the Board declined President Nixon’s request. The company declared bankruptcy on Sunday, June 21. (It would operate under bankruptcy protection for the next five years. Some of their rail routes were assumed by Amtrak upon its creation in 1971. By 1976, Penn Central was unable to emerge from bankruptcy as a reorganized company and was basically nationalized when Congress folded it and five other failed small railroads into the federally chartered Consolidated Rail Corporation, also known as Conrail.)

In 1970, however, many inside the Fed were concerned about the consequences of Penn Central’s bankruptcy filing. It was thought that the default of the company’s commercial paper could spur a contagion where other large companies that relied on the Penn Central debt contracts as a source of funds for their daily operations might default on their debts, and so on. There was also a concern that the market would be rattled by uncertainty and investors would be unable to discern which commercial paper issuers were likely to default next if at all. The sense among some was that the discount window should be used to head off these potential ripple effects.

So, the Fed decided to contact member banks over that weekend and told them that if they made loans “to enable their customers to pay off maturing commercial paper and thus needed more reserves, the Federal Reserve discount window would be available.” Columbia University economist Charles Calomiris has noted that the word “available” is the most important part of this statement. It effectively meant that member banks could borrow from the Fed for

the purposes of “pass through” loans to commercial paper issuers and would be able to do so without incurring any costs other than paying the discount rate — in other words, the sorts of restrictions put on discount window borrowers in the form of additional bank audits or other nonpecuniary penalties would be lifted for this sort of lending. Indeed, the Federal Reserve Board’s Annual Report in 1970 confirmed that the approach to discount window lending at this time was meant to finance borrowing by companies uncertain about whether they could rollover their soon-to-mature commercial debt.

Consequently, borrowing of reserves by large commercial banks — the institutions that were the main source of funds for these companies — tripled between June 24 and July 15. Calomiris estimates that this almost exactly offset the amount of the decline in the value of the commercial paper outstanding in the debt markets.

That wasn’t the only step the Fed took. There were some small actions to increase the money supply through open market operations. The Board also changed what was known as “Regulation Q” which mandated a ceiling on the interest rates banks could pay to depositors. This limit, in place since 1933, had the effect of making bank deposits a less attractive option for investors. The Fed’s action in 1970 exempted deposits above \$100,000 from the interest rate ceilings. The result was a flood of new deposits into commercial banks. This larger pool of loanable funds amounted to an increase from \$14 billion in June 24 (the day after the change to Regulation Q was approved) to \$26 billion by year’s end. Liberalization of this obviously counterproductive policy is perhaps the one thing that economists can agree was a good outcome of the Fed’s response to the Penn Central bankruptcy. It was a formative step in the eventual demise of Regulation Q, which was eliminated altogether in 1986.

As a lender of last resort, however, the approach that was favored by some policymakers at the Fed was one that harkened back to the Depression-era conception of the Fed’s role. The chairman of the Federal Reserve at the time, Arthur Burns, made no secret of his interest in expanding the Fed’s presence. In a statement to Congress on July 23, he revealed that during the events of the previous month, the Fed had prepared “standby procedures” to allow them to make direct loans to all sorts of firms unable to secure credit in private markets.

For the next 20 years, the Fed would assist in the federal government’s awarding of emergency credit, but in a different way. They served as the fiscal agent for the federal government’s loan guarantees to Lockheed in 1971 and Chrysler in 1979. The same goes for the emergency loans that went to the city of New York in 1975. These forms of assistance, however, were launched on an ad hoc basis.

In 1991, more than 30 years after section 13(b) was repealed, a broader conception of the Fed’s role as lender of last resort was finally codified by the Federal Deposit Insurance Corporation Improvement Act. The new amendment to paragraph 3 of section 13 clarified that the Fed could

advance credit directly to nondepository institutions — for example, securities firms.

The Past and Future of Fed Lending Policy

Even today, debates still occur over whether the Fed made the right decision about its discount window operations in that fateful summer of 1970.

Some argue that it's not immediately clear that the discount window actions were necessary to head off any ripple effects in the Penn Central episode. Open-market operations alone could have expanded the money supply to meet the demand for credit that would have resulted from any commercial paper default. In a case like that, intermediaries in the private banking system, not the Fed, would be the ones determining where the demand for the loanable funds was highest. Some economists, like former Richmond Fed economist Marvin Goodfriend, suggest that the discount window is unnecessary for this reason and is no longer required for maintenance of the money supply as it once might have been.

Nor does everyone buy the contagion argument used to justify the lending actions of the Fed. Anna Schwartz suggested in a speech at St. Louis University in 1992 that commercial paper issuers that faced difficulty in 1970 weren't in that position because of turmoil in the credit

markets. Instead, it was because they were companies that might have deserved to fail for a variety of reasons, all of them particular to the companies themselves. Reliance on commercial paper was a by-product, not a cause, of their troubles. From a policy perspective, Schwartz suggests that the Penn Central episode “fostered the view that bankruptcy proceedings by a large firm [can create] a financial crisis, and that, if possible, bankruptcy should be prevented by loans and loan guarantees: a ‘too big to fail’ doctrine in embryo.”

Meanwhile, economist Allan Meltzer of Carnegie Mellon University, who has written a history of the Federal Reserve, channels Bagehot when he wonders what the Fed policy really is. As he wrote in the *Wall Street Journal* on July 16, 2008, “In its 95-year history, the Fed has never made a clear statement of its policy for dealing with failures. Sometimes it offered assistance to keep the bank or investment bank afloat. Other times it closed the institution. Troubled institutions have no way to know in advance whether they will be saved or strangled.”

The assumptions about a central bank's role as a lender of last resort have come a long way since the days of Thornton and Bagehot. The wisdom of those changes is something economists continue to debate — especially during the current period of financial turmoil. **RF**

READINGS

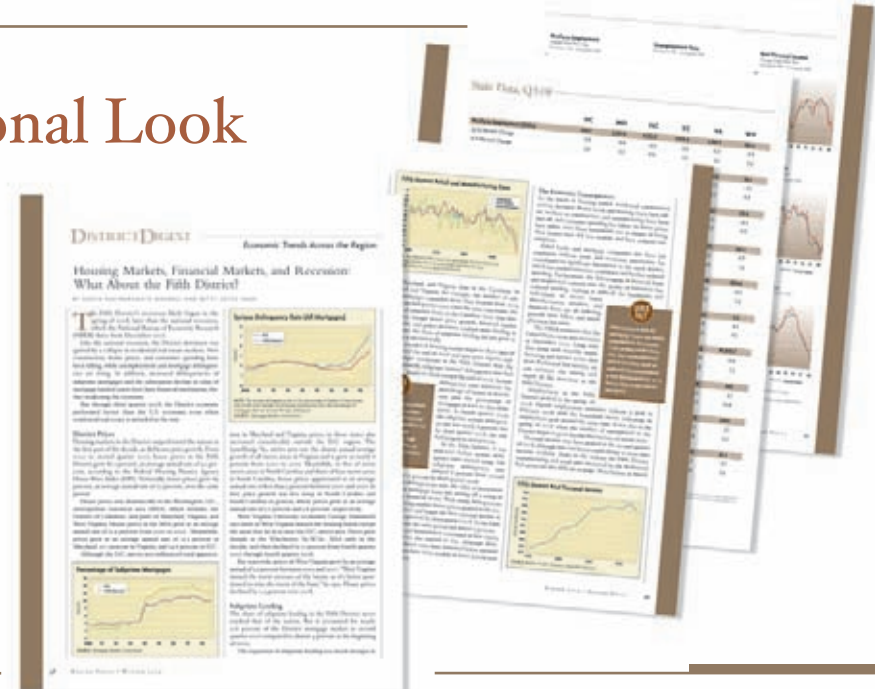
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A Closer Regional Look at Fifth District trends and issues

Check out **District Digest** on page 48.



National Debt

BY DAVID VAN DEN BERG

When you hear debates about the fiscal health of the nation, it's important to put the rhetoric into context. Many observers worry about the amount of money that the U.S. government owes to its bondholders — the “national debt.” But how the debt grew to its current size and the trend of federal expenditures are important matters to keep in mind when sorting out the arguments about the national debt.

When the federal government spends money, that money has to come from somewhere. Most government spending is financed by tax revenue. But the federal government usually spends more than it takes in, resulting in a budget deficit. So, to pay for expenses beyond the amount of taxes collected, the government borrows by selling Treasury securities — short-term “Treasury bills” or long-term “Treasury bonds” — to the general public. In short, unbalanced budgets drive an increase in the federal deficit which in turn is added to the total sum of the national debt.

America's total gross national debt is roughly \$11 trillion today. Of that, about \$6.8 trillion is the amount of debt held by the public. Of the two components that comprise the national debt, this is the one that is the most commonly reported. It includes all federal debt held by individuals, corporations, state or local governments, foreign governments and other entities outside the federal government. These numbers are reported by the Bureau of Public Debt of the U.S. Treasury Department. China and Japan are the largest foreign holders of this publicly held debt.

The rest, about \$4.2 trillion, is held in intergovernmental accounts, like the respective trusts funds for Social Security, Medicare, and the retirement accounts for military and civil service personnel. The reason these trust funds hold Treasury securities is that the payroll tax which finances most of the spending on these programs generates more revenue than needed to pay for current services that the trust funds finance. Congress often borrows this surplus revenue for spending on other programs and issues Treasury securities to these trust funds in return.

These debt numbers might sound big, so it's important to put them in context. The national debt figures are typically measured as a percentage of gross domestic product (GDP), the primary measure of the nation's economic activity.

In the past, debt held by the public rose substantially during periods of war and, later, during periods of increased

spending during economic downturns. The debt was 90 percent of GDP in the early 1950s, after World War II had ended and the Korean War was underway. By the 1970s, it was below 30 percent. It crept back up to 49 percent by 1996, but it has declined to about 41 percent in the last complete fiscal year (FY 2008). The decline after 1996 was due to a four-year period of budget surpluses that allowed the U.S. government to slowly pay off debt.

Currently, debt held by the public is about 47 percent of GDP. The total gross national debt is 74.6 percent of GDP. But that doesn't mean the full burden of the debt is borne by current taxpayers. The year-to-year burden of the national debt is the cost of paying the interest on the Treasury securities. Today, this “carrying cost” for the national debt is \$249 billion, or 1.7 percent of GDP.

Economists and policymakers are divided about whether the current debt levels could have adverse consequences for economic growth or the country's future. Some are concerned that a growing debt burden will “crowd out” private investment — money that might have gone to other investments will instead go to purchasing safe Treasury bills. Others suggest that current debt levels are sustainable and point out that there is no correlation between

interest rate changes on Treasury bonds and the present level of the national debt.

If history is any guide, government debt will always be with us. For starters, emergency military actions are unpredictable and have been funded by the issuance of debt throughout U.S. history. In addition, the purchase of Treasury securities is an important tool used by the Federal Reserve to conduct monetary policy.

The size of the gross national debt may be the least of our worries, however. An additional obligation that is not included in the national debt calculation is the future benefits that the U.S. government will pay to retirees in the years to come. The number of retirees — who receive their benefit payments out of current revenue — will soon dramatically outstrip the number of workers paying into the Social Security and Medicare system. This mismatch over time will result in trillions of dollars of “unfunded obligations” that will have to be financed by more Treasury debt, greater tax revenue, or cuts in benefits to retirees. Some argue that this implicit debt could have the potential to substantially dwarf the gross national debt and indeed harm the U.S. economy.

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ILLUSTRATION: TIMOTHY COOK

Does Democracy Lead to Economic Growth?

BY MATTHEW CONNER

For years, the debate about which form of government is economically optimal has raged among politicians and economists. Some believe that democracy is essential to sustained economic growth, while others remain skeptical of the evidence supporting this view. Meanwhile, the world has seen a move toward democracy during the past 30 years, with many totalitarian states becoming democratic. However, there is still one question at the center of this debate: Do democratic reforms bring economic growth?

In a recent article, researchers Elias Papaioannou and Gregorios Siourounis of Dartmouth College and the University of Peloponnese, respectively, sought to challenge previous findings that democracy had little to no statistically significant effect on economic growth. In contrast with prior analysis that mostly focused on differences between countries, this paper explores “within-country” growth effects. To do that, the authors compared economic outcomes before and after the enactment of democratic reforms around the world during the four decades between 1960 and 2003. This includes the so-called “Third Wave of Democratization” mainly in Africa, Asia, and Latin America and the reforms adopted in many formerly communist countries during the early 1990s.

To avoid some of the pitfalls associated with categorizing different democratic reforms, the authors created a new dataset of what they call “permanent democratic transitions.” To classify the transitions, the authors answered four general questions:

- 1) Were the legislative or presidential elections free and fair?
- 2) Were civil liberties and political rights respected?
- 3) Was the franchise inclusive of the majority of the population?
- 4) Did the elected officials enjoy real governing capacity?

The study focuses on whether the shift to a democratic government accelerates, decelerates, or has no effect on economic growth by examining the annual real per-capita GDP before and after reform. The timing of initial democratization is defined by the authors as the date of the first “free and fair” election or the adoption of a new “democratic constitution” after prolonged autocratic rule.

The authors found that shifting to a democratic government resulted in a nearly 1 percent annual increase in the

growth of gross domestic product. During the transition to democracy, however, growth drops significantly, due to the high costs related to the transition. But examination of long-run trends shows a higher stabilization level. Their analysis also shows that even moderate democratic reform can yield decent growth gains, while “reverse transitions” (backsliding away from democracy) are associated with slower growth.

Yet it still might be unclear that democratic reform is solely responsible for economic growth. Perhaps economic reforms either precede or accompany political reforms. The authors point out that their model does not distinguish

between different types of democracies, for example, presidential or parliamentary. That would be vital to addressing the traditional “public choice” and “institutional” schools of analysis, which state that certain built-in frictions, such as checks and balances in a representative system, might be more important to checking certain legislative impulses — like

restrictions on various economic freedoms — which can hinder economic growth. Also, because the authors do not take into account whether specific legal rights — say, how well the legal system protects property rights — exist in each country, it is hard to determine whether democracy is the main determinant of the increased economic growth or whether the growth can be traced to the legal regimes that might accompany the presence of democracy.

Other researchers choose to focus on specific types of cultural or legal precursors for economic growth. In a widely cited article, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny have stated that other variables have a more positive influence on growth than the mere presence of democracy. For example, common law countries fare better than civil law countries, while predominantly Protestant countries perform better economically than either Catholic or Muslim nations.

While economic growth may be correlated with democratic reform, the direction of the causation remains a question. Papaioannou and Siourounis concede this possibility when they write that it could be “growth that consolidates the democratic process rather than political reforms causing growth.” Although their paper is a useful contribution to the empirical analysis of how governmental institutions influence development, their conclusions should — and, no doubt, will — be subjected to careful examination.

RF

“Democratisation and Growth”
by Elias Papaioannou and Gregorios
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October 2008, vol. 118, pp. 1520-1551.

States Receive Funding from Stimulus Bill

BY DAVID VAN DEN BERG

Money from the American Recovery and Reinvestment Act of 2009, better known as the stimulus bill, is flowing to states around the country and the Fifth District.

The \$787 billion legislation will provide at least \$18 billion to the states of the Fifth District to fund a variety of projects like road building and school improvements, according to the National Conference of State Legislatures (NCSL). The amount of money states should expect to receive is based on funding formulas that take into account a state's population, unemployment rate, and number of low-income residents, said Michael Bird, federal affairs counsel with the NCSL.

Most of the money provided is for specific programs and must be used for those purposes. North Carolina's allocation is the largest in the District, at about \$6 billion, while West Virginia will get \$1.4 billion and the District of Columbia will get \$876 million. Virginia will receive \$4.5 billion; Maryland will receive \$4 billion, while South Carolina is slated to get \$2.9 billion. These allocations exclude additional funds they will receive later this year through grant programs, disbursements for traditional unemployment benefits, and the food stamp program. This money is not meant to be a permanent fixture in the federal budget: The new money is slated to stop flowing to the states on Sept. 30, 2010.

Here's a look at some of the funding coming to the Fifth District, based on numbers obtained from the NCSL:

Medicaid

The formula by which the federal government allocates Medicaid matching dollars will be altered so as to allow an increase in federal spending on that program. Additional amounts of funding will be given to a state if its unemployment rates rise higher. In the Fifth District, North Carolina will receive the most additional Medicaid funding, \$2.35 billion. Maryland will receive \$1.63 billion, while Virginia will receive \$1.47 billion. South Carolina's Medicaid allocation will rise by \$860 million, while West Virginia's will rise by \$450 million.

All together, this amounts to a two-year increase (FY 2009 and 2010) in Medicaid spending of \$6.7 billion for the Fifth District states (excluding the District of Columbia). According to preliminary estimates from the National Association of State Budget Officers, that is almost double the amount — \$7 billion — that these states received from the federal government for that program in fiscal years 2007 and 2008. This growth is partly a result of an expansion in the number of people who can now qualify for Medicaid.

Fiscal Stabilization Fund/Education

Of the \$54 billion in the bill's "fiscal stabilization fund," about \$45 billion is directed at education. States will receive a total of \$40 billion for education-related purposes. Another \$5 billion goes to the U.S. Secretary of Education to allocate to states for school improvement projects.

However, there is a pot of money in the "fiscal stabilization fund" over which state governments will have complete discretion. States will receive a total of \$9 billion, allocated by a formula, to use as they see fit. North Carolina will receive \$254.3 million of this money, while Virginia will receive \$219.15 million. Maryland and South Carolina will receive at least \$125 million each. West Virginia will receive \$49 million, while the District of Columbia will receive \$16.3 million. "This was seen as money the states could use to help balance their budgets without being stuck in a specific funding silo," Bird said.

Unemployment Benefits

Most of the stimulus bill does not require state legislative changes for states to receive money. But to receive all available money for expanded unemployment benefits, states that have not already done so will have to change their laws about eligibility for those benefits. These changes would expand the benefits to workers not formerly covered by state unemployment insurance programs.

Not all governors are interested in making these changes, which could have a long-term impact on state budgets. South Carolina Gov. Mark Sanford opposes changing his state's laws. "After the federal money runs out, we're left to pick up the tab at the state level," said Joel Sawyer, a Sanford spokesman. Twenty states have changed their laws regarding unemployment eligibility and how those benefits are calculated. All of those states did so before President Obama took office, Bird said.

Infrastructure

Expenditures in this funding category include money to build or improve highway and bridges. North Carolina and Virginia will receive the District's largest allocations for this construction, at \$736 million and \$694 million, respectively. South Carolina will get \$463 million, followed by Maryland with \$431 million. West Virginia (\$210 million) and the District of Columbia (\$123 million) will receive the least.

Taxpayers will be able to monitor stimulus expenditures on a federal government site, www.recovery.org. Maryland, Virginia, West Virginia, North Carolina, and South Carolina have launched similar Web sites to allow their residents to track stimulus spending.

RF

How Consumers Use Plastic — and Why

BY MATTHEW CONNER

“Credit Card Debt and Payment Use.” Charles Sprenger and Joanna Stavins, Federal Reserve Bank of Boston Working Paper 08-2, May 2008.

Nearly half of credit card holders in the United States can be referred to as “revolvers” — those who regularly carry balances on their cards. Those who pay off their balance every month can be called “convenience users” of credit cards because they use the cards as an easy form of payment technology. The authors of this study examine the differences in the use of payment technologies between these two groups of people.

Using data from the Survey of Consumer Payment Preferences for more than 1,800 individuals who use both debit and credit cards, the authors examine the four different ways these people can pay for goods: credit cards, debit cards, checks, and cash. They report significant evidence that individuals regularly carrying revolving debt are more likely to substitute the use of a debit card for that of a credit card. In other words, these individuals use credit cards for a significantly lower percentage of their total payments than do convenience users of credit cards. However, there is no significant difference in the use of cash and checks between the two groups.

From the same survey, the authors infer that revolvers use debit cards more often not because they perceive it as an easier form of payment at the check-out. Instead, they are more likely to use debit cards because they see them as a good way to control their spending.

“Are Children ‘Normal?’” Dan Black, Natalia Kolesnikova, Seth G. Sanders, and Lowell J. Taylor, Federal Reserve Bank of St. Louis Working Paper 2008-040C, October 2008.

In 1960, Gary Becker first posed the question: Does the demand for children follow the pattern of a “normal” good? In consumer theory, increases in income induce greater consumption of “normal goods.” So, to restate Becker’s question: As the incomes of married households rise, will that lead to an increase in fertility?

The authors of this paper evaluated this question using data from the 1990 census. They discovered that fertility and household income are inversely related for non-Hispanic white married women. This suggests that children are not “normal goods.” However, when the amount of education the women have is held constant — that is, when you compare a college graduate to another college graduate — a positive correlation between the husband’s income and fertility appears. From this brief cross-sectional examina-

tion, the authors conclude that in the United States, fertility exhibits the characteristics of a normal good if the women being compared have similar human capital.

In order to more fully answer the paper’s motivating question, the authors turn to a natural experiment: They examine the effect of a large increase in coal prices in Appalachian coal-mining counties during the energy shock of the 1970s. The large increase in the price of coal had its largest positive impact on the income of men because mining mostly employs males. Fertility data for the same period shows an increase in births in high-coal counties relative to non-coal counties during the coal price boom. Thus, children do indeed appear to be “normal.”

“The Role of Lenders in the Home Price Boom.” Richard J. Rosen, Federal Reserve Bank of Chicago Working Paper 2008-16, November 2008.

Home prices rose at a steady rate of approximately 1 percent annually from 1983 to 1996. After that, prices started to increase at the much faster pace of 2.8 percent from 1997 to 2001 and an even sharper 7.6 percent from 2001 to 2005. In this paper, Rosen examines the effect that competition among lenders had on this price boom.

The two main types of mortgage lenders are depository institutions (like banks) and mortgage brokers. Comparing home price data collected from the S&P/Case-Shiller Home Price Index, Rosen discovers that the rate of home price increases began to rise when the share of mortgages in an area were issued by banks instead of mortgage brokers. Rosen notes that this phenomenon might be explained by the nature of the institutions. Banks naturally have higher overhead than the mortgage brokers, but the banks can capitalize on their reputation and the fact that they often have pre-existing relationships with potential borrowers who hold other accounts with the bank (checking, saving, etc). Thus, banks can offer lower interest rates to these customers and increase their market share.

When national housing markets get hot, however, mortgage brokers chip away at the market share of the banks. The increase in mortgage securitization allows mortgage brokers to compete with banks because it allows them to make loans without raising much capital. Yet that is also true of banks. So, to compete in an environment of high rates of growth in housing prices, banks seem to become more risky in their lending compared to earlier periods. Between 2002 and 2005, for instance, Rosen notes that the average ratio of the loan amount to the borrower’s income increased substantially. **RF**

HOW THE CORPORATE BANKRUPTCY SYSTEM BENEFITS AND HINDERS THE ECONOMY

BY STEPHEN SLIVINSKI

When Richmond-based Circuit City — the second-largest consumer electronics retailer in the nation — declared bankruptcy on Nov. 10, 2008, the company still had some options to keep itself alive. Although the withdrawal of the \$1 billion bid for the company by Blockbuster Inc. in July must have been fresh in the minds of the firm's managers, they declared in the bankruptcy filing their intent to emerge from the court proceeding in the first half of 2009.

On paper, the immediate problem that afflicted the company was the massive amount of debt it had accumulated to sustain its operations in the face of slow sales. The managers were hopeful that the company could be valuable to a new owner and scrambled to cobble together a deal with some interested buyers, and the judge in the case set a January date to auction off the firm.

On the morning of January 16, the company's creditors and nearly 34,000 employees found out the end had

arrived. That's when Judge Kevin Huenekens agreed to Circuit City's request to close its doors for good and liquidate its inventory.

The firm's demise might not have been much of a surprise to the creditors and vendors who supplied Circuit City's inventory in those dying days. Fearing poor sales at the store's locations in the 2008 holiday shopping season, vendors began to restrict the flow of merchandise as early as November. The creditors of the company, led by Bank

KNOW WHEN

of America, told the firm's managers they simply could not provide funding to keep the 500-plus locations in operation. Market players seemed to be saying what Circuit City's corporate heads feared: The company was no longer economically viable, unable to compete in a world full of popular online retailers and other low-cost shopping options.

In all bankruptcy proceedings, the most important question is whether a particular company has simply fallen on hard times or whether it's not economically viable anymore, such as a typewriter manufacturer in a world where typing has migrated almost universally to computer keyboards. For many businesses, the day may come when the question their managers have to answer becomes one familiar to poker players: When do you fold? Not to grapple with such a question could cause a variety of firms that should whither away to survive instead, and vice versa. Either outcome would be bad for economic growth.

The institutions in the United States that have been created to officiate the process are the bankruptcy courts. Of course, simply declaring bankruptcy doesn't automatically imply that a company is doomed. The system has two tiers. The form of bankruptcy that Circuit City entered — called "Chapter 11" after the title of the section of the federal Bankruptcy Code that created it — was originally designed to create a means by which firms could reorganize themselves and survive by renegotiating costly contracts or restructuring their debt obligations. That's a distinctly different approach than that taken in Chapter 7 of the Bankruptcy Code in which a company is liquidated. As in the case of Circuit City, liquidation can be the outcome of a Chapter 11 proceeding that does not result in a reorganization or sale of the firm.

There are many companies battered by bad economic times that can still survive if they just have a safe harbor in the storm. Reorganization in Chapter 11 gives them such an option, and it's an important one. But if a company is likely to be liquidated anyway because it simply isn't able to survive in a modern marketplace, why would it go through the hassle and cost of trying to reorganize? And since bankruptcy proceedings ask a single judge to be the arbiter of whether a firm is viable as an economic entity, it's also a concern to some that current bankruptcy practice assumes one person with incomplete knowledge will be able to accurately predict the future contours of the U.S. economy. Firms that probably shouldn't be reorganized might be able to survive for a bit longer if they find a sufficiently

sympathetic judge, and that creates economic inefficiency. "There is an opportunity cost to keeping a nonviable firm alive for too long," says Todd Zywicki, a professor at George Mason University Law School. For instance, economists Ricardo Caballero, Takeo Hoshi, and Anil Kashyap have argued that subsidies to money-losing "zombie" firms have helped keep those businesses afloat, while depressing the creation of new competitors.

These concerns have sparked a debate within academic, legal, and economic circles about how bankruptcy functions in the United States. In the view of some, the current system could lead to adverse consequences alongside its benefits.

Railroads and the Logic of Bankruptcy

You can't understand modern bankruptcy law without knowing the story of the 19th century U.S. railroad industry. "If you talk to most legal scholars about Chapter 11, they usually bring up the railroads as the poster children for why we need a law of corporate reorganization," says Douglas Baird of the University of Chicago Law School.

After the Civil War, the American economy became increasingly national in scope thanks in part to the evolution of rail travel. The number of miles of train track more than tripled between 1870 and 1900, allowing the expanded movement of goods and eventually an increase in the number of newly industrialized manufacturing centers.

In fact, the railroad companies would become the first modern corporations in U.S. history. Before 1860, the railroads were financed mainly by the farmers and merchants who benefited from the lines. After 1860, however, railroad companies had to seek capital from New York financial houses. This effectively made them a trans-state operation in terms of capital structure as well as in the services they provided.

Between 1865 and 1890, railroad competition intensified. Cartels formed and collapsed. Then the early 1890s witnessed one of the United States' worst economic downturns at the time. By the mid-1890s, many railroad companies were unable to make the payments on their bonds, leading judges to reckon with how to deal with high-cost operations that had numerous investors.

The approach the courts took was a reorganization of the companies. The goal was to rearrange the capital structure and allow a firm to provide ongoing value to creditors beyond the temporary economic tumult. The only other alternatives would have been to sell the firm to

TO FOLD 'EM

new owners or to terminate the company's operations, tear up the railroad tracks, melt them, and sell them for scrap. The second option would have destroyed a tremendous amount of economic value. The railroad companies were surely still more valuable than the sum of their parts.

But capital markets were relatively undeveloped at the time and that made it very difficult to engineer a sale at a price acceptable to both parties. So the simplest way to save the company was to reorganize it and allow the railroad, as the legal scholars say, to retain the value it had as a "going concern."

Also, there was the sticky matter of the type and number of creditors. "One of the reasons that it was compelling to reorganize the railroad companies is because they had massively chaotic capital structures," says Baird. "The Atchison, Topeka and Santa Fe Railroad Company, for instance, issued over 40 different types of bonds held by thousands of bondholders all over the universe."

The disparate nature of this large group of creditors meant they would not have been able to collaborate and agree on whether to sell the company or how to restructure it. The transaction costs of working out a reorganization agreement would have been very high. "One of the main reasons to have a collective procedure is that the creditors can't work together outside of bankruptcy," explains Baird.

That alone seems like a big enough problem. But imagine what might happen if a group of creditors decides they don't want to restructure and rush to stake their claim to the railroads assets? That could set off a rush to disinvest in the company, throwing it further into financial straits and leaving those who are late to the feeding frenzy without much to show for it. A system of bankruptcy that provides a "safe harbor" for firms is important in such an environment.

So it should be no surprise that the railroad example is one of the most common historical examples in the literature on bankruptcy law. But there's a catch, argues Baird: It's really hard to argue that the logic of the example applies to the modern world. "The traditional justification for reorganization is that the firm cannot be sold as a going concern, there's a lot of firm-specific value at risk, and the creditors cannot cooperate outside of bankruptcy. Reorganization can only be justified if all three of those are true at the same time. Today, in many cases, they are not all true."

Baird suggests that most firms today don't own specialized assets that are only valuable in their current firm-specific context. Most companies own or lease assets, like machinery — or, in the Circuit City example, retail space — that would indeed have valuable alternative uses to another firm. In fact, much of the value of many modern firms is portable: It consists of the human capital of the employees.

Business success instead rests largely on the originality of a company's approach. "Today, bankruptcy law can

affect your capital structure, but it can't make you successful in the marketplace. That depends on your business model," explains Robert Rasmussen, dean of USC Gould School of Law.

The specter of the collective action problem has been lessened in the modern world too. It's rarely the case that a single firm has a large number of creditors. "If you look at many firms filing for bankruptcy today, there is often one creditor that has a revolving credit line and that person or firm is basically making many of the important decisions. There's no coordination problem there," says Baird. In fact, many corporations have been able to renegotiate their debt contracts outside of court and never have to declare bankruptcy.

The Rules and Costs of the Bankruptcy Game

Even if the traditional railroad paradigm were applicable today, the bankruptcy proceeding may still have shortcomings as a result of its structure. Like any legal proceeding, the bankruptcy process has its own unique set of rules and players.

As Zywicki notes, the players with the most power in the bankruptcy process are the firm's managers. While creditors can force a company into a bankruptcy proceeding, those cases tend to be rare. Instead, it's usually the firm's managers that are in the driver's seat. "They control when the bankruptcy is going to happen and they control where the bankruptcy will be declared," Zywicki says. Because current law doesn't require companies to declare bankruptcy in the state where they are incorporated, managers retain the ability to "forum shop" and scope out the landscape for a friendly judge.

Once a firm's managers choose to declare bankruptcy, they have a set period of time in which to present a reorganization plan that must win the approval of the creditors. If they don't approve the plan or they can't get a buyer for the firm, then the company could head to liquidation.

According to economist Michelle White of the University of California at San Diego, these rules create the wrong incentives and cost the economy in the process. "In Chapter 11 there is a tendency for too many firms to be saved," she says.

The main reason is that the firm's managers should be expected to know more about the actual state of the firm than the creditors or stockholders. If a firm is actually in worse shape than the creditors realize, the managers have an incentive to get them to agree to a reorganization plan rather than liquidate the firm. Inability to do so might result in those managers losing their jobs and equity in the company. "It gives an incentive for bad firms to pretend they're good firms," says White. "Those voting on the reorganization plan may not know which type the firm is."

If the current system leads to keeping alive too many firms that should be liquidated, it could lead to capital being trapped in a less-efficient use. This deadweight cost

to the economy has been estimated by White as potentially 20 times as big as the amount of money spent on direct costs like lawyers' fees.

The success rate of corporate reorganizations has come into question by other scholars. Finance professor Edith Hotchkiss of Boston College found that one-third of the firms that successfully restructured in Chapter 11 required further restructuring in three years. "Her results are consistent with a model in which some inefficient firms reorganize even though they should liquidate," points out White in a 2005 working paper for the National Bureau of Economic Research.

So, much of the debate over bankruptcy law really does come down to the effective use of information. The ultimate decisions in a bankruptcy proceeding are made by a single judge. But a single judge is unlikely to have all the decentralized information that markets can summon, or even know how to best utilize that information even if he had it.

"Bankruptcy puts the judge in a position to play central planner," says Zywicki. "The fundamental decision the judge is making is whether the current deployment of assets is more valuable than an alternative deployment of assets in the economy." By that standard, current bankruptcy reorganization procedures may be suboptimal.

Making Bankruptcy More Efficient

Each year, hundreds of thousands of firms fail. In fact, most firms' managers never see the inside of a bankruptcy courtroom. According to the Small Business Administration over 540,000 businesses fail each year. By contrast, the number of firms that enter bankruptcy is only a tenth of that.

Those that do enter bankruptcy, however, are facing a whole new set of realities. Baird argues that over time Chapter 11 proceedings have become the most useful when they serve as a controlled environment in which to conduct the speedy sale of a company, not to haggle over a reorganization.

A similar approach to bankruptcy is one when Chapter 11 becomes merely a vehicle by which to auction off the firm. In this "mandatory auction" scenario, bidders — some of whom could have better information than a typical bankruptcy judge or corporate debtor — would vie for the ownership of the firm as a going concern. At that point,

the decision whether to liquidate or reorganize would be made by the new owner.

In any case, the assumptions of corporate bankruptcy law would need to change. "In an ideal world, bankruptcy law would aim to reduce the cost of capital," says Rasmussen. "You'd want to have a system that effectively flushes the losers and salvages the winners. If you could do that, it should lower the cost of capital because people know the system won't burn money trying to resurrect companies that are not viable." Making auctions the main purpose of bankruptcy proceedings would do that.

Rasmussen favors making the system even more decentralized. He advocates what he calls a "menu approach" to debtor-creditor contracts. If legal rules affect investment decisions and the cost of capital, then uncertainty about what might happen during a bankruptcy proceeding in the future would have an influence on the risk premiums charged by creditors today. So why not allow the rules to be set by the companies themselves in their charters?

"You can imagine a world where a company can agree at the front end to limit its options if it falls into financial distress," says Rasmussen. An example would be a debt contract that gives the primary creditors more control over business decisions in periods of economic distress or other similar scenarios. Venture-capital investments are often structured in this way.

This option, however, is difficult to achieve in the current bankruptcy regime. No company can legally bind themselves never to resort to the bankruptcy courts. Still, this hasn't stopped many firms from finding some rather sophisticated ways of contracting around this prohibition, although the costs of doing so are quite high. Rasmussen's alternative would make reorganization within bankruptcy courts one of many options, not the mandatory default.

How policymakers deal with the "creative destruction" that leads economically unviable companies to fold and allows the resources to be reallocated by the market to something more useful is important. What mechanisms we use to assist that transition in an evolving modern economy are vital. Making sure those same mechanisms don't hinder that process is potentially even more crucial. So perhaps, as critics of the current bankruptcy regime argue, it is about time we get more creative with our approach to the legal mechanisms of creative destruction.

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The Language of Local

Community papers survive by sweating the small stuff

BY BETTY JOYCE NASH

At the *Pilot* in Southern Pines, N.C., editor David Woronoff's office sits smack-dab by the front door. He brags about it.

"We are accessible, and I think that is what makes us unique," he says. The *Pilot*, a thrice-weekly newspaper with a circulation of about 15,000, finished 2008 with revenues up 5 percent over 2007, although Woronoff calls November and December receipts "dismal." Still, he's convinced that community news is a valuable commodity. "You can't get what we do anywhere else. That kind of unique selling proposition is what will keep community newspapers going for a very long time."

The big metro dailies are in trouble. Many have bailed out of covering satellite towns, and that's helping community papers like the *Pilot*, with circulation less than 30,000. The paper's circulation numbers are stable. It's surviving on community advertising and local news, including photos of 4-year-olds on their birthdays.

"Community newspapers have a franchise for local news that in most cases is not being invaded by some information source using the Internet," says Al Cross of the University of Kentucky's Institute for Rural Journalism and Community Issues. They've established a product that's valuable to a small group of people, the news in their local community.

Niche News

You don't have to read the fine print to see how the big metro dailies are struggling — they publish fewer pages, they've let staff go, they've had their lunch eaten (and dinner, too, since half of newspaper revenues came from classifieds) by Web outfits like Craigslist and Monster. Auto company and real estate woes have choked off the remaining classified revenue. To add insult to injury, there's even a Web site to chronicle their demise: www.newspaperdeathwatch.com.

But community papers, says longtime media analyst John Morton, are doing reasonably well. They have traditionally earned less than big metro dailies from classified ads (about 30 percent on average), which means they weren't as vulnerable when those ads migrated from print. Of course, the recession has eroded everybody's ad revenue, including electronic media, but community papers are "certainly not in any kind of calamitous state on their profit and loss statements." In fact, small papers in a metro daily's portfolio, like those in the New York Times Regional Newspaper Group, may subsidize bigger siblings like the *Times*, Morton says.

But a community newspaper isn't a daily. They are found in dense urban neighborhoods with retail, small towns out-

side cities, and rural communities, including very small towns. They can be weekly, twice, or thrice weekly and, by Cross' definition, circulate fewer than 30,000 copies. "Above that, and you're serving communities that don't have enough in common." They are typically subscription papers that cover at least the cost of postage, and in rural areas are delivered by mail.

This category usually does not include the pure "shopper," a paper that has no editorial content, and also excludes the alternative weekly — such as the *Washington City Paper* — which is in a category all its own. (Alt-weekly readership declined in 2008.)

Weekly Reader

A 2008 readership survey found that 86 percent of people over age 18 read a community paper every week in cities and towns served by these papers, defined as those with up to 25,000 in circulation. This Community Newspaper Readership Survey was based on a stratified sample of these newspapers and conducted by the Center for Advanced Social Research of the University of Missouri's School of Journalism.

Financials — in fact, any data for these small papers — are tough to track because most of them are in private hands and, frankly, don't want the competitor in the next town to know their business, says Brian Steffens of the National Newspaper Association (NNA), a lobbying group for community papers. Of NNA members, 54 percent are family owned, 24 percent corporate owned, and 21 percent are independent.

Even in publicly owned chains, numbers typically aren't broken out by property. Media General of Richmond, Va., for example, owns 275 community papers, 10 in North Carolina, but doesn't comment on earnings or individual papers, says spokesman Ray Kozakewicz. The company has cut its staff of 772 by about 22 percent from a year ago.

In markets where a community paper is the only game in town, they're thriving because advertising is local. National ad budgets get divvied up three ways: print, broadcast, and Internet. And in a small town, there's often no local television. "If it is, it's regional. Your television station might be from Kansas City or some other large city, but there's no real competing media," Steffens says.

Chris Stadelman, editor and publisher of the weekly *Parsons Advocate* in Tucker County, W.Va., says the paper he runs with his wife, Kelly, earned record revenues in 2008. As

“the only newspaper in the whole world published by and for the people of Tucker County,” the *Advocate* is prospering.

“Our total revenue is up more than 20 percent since we purchased the newspaper, the bulk of that from advertising.” The Stadelmans make up half of the paper’s four full-timers.

Community papers are as varied as the towns they occupy, defying the one-size-fits-all definition, says Cross. Some thrive on chicken-dinner coverage, news about feel-good events only; others keep a vigilant eye on local issues and win press awards for doing so. Many aim to do both. Stadelman reports that his paper has filed a Freedom of Information Act request for financial details about a federally funded clinic in town. In addition, the paper has “forced the mayor to admit inappropriate conduct in executive sessions.”

“At the same time, it’s even more critical to be fair to people in such a small community,” he says. “With 7,000 people in the county, we deal with a lot of the same faces on a regular basis.”

Legal Ads and the Phone Book Too

The *Pilot* was named the best small paper in the nation in 2002 by the Inland Press Association, a trade group. Woronoff, also part owner, says the paper will “always be small town and we will never be small time.”

Okay, so the *Pilot* has better-than-average expertise behind it. It’s owned by a former associate and the family of the *Raleigh News & Observer*. The McClatchy Co. bought the *N&O* in 1995. (McClatchy also owns the *Charlotte Observer*, the *Chapel Hill News*, the *Cary News*, the *Herald* in Smithfield, and the *Eastern Wake News* in Zebulon, N.C.) Woronoff’s relatives are silent partners and acquired the *Pilot* in 1996.

The *Pilot* set out to become indispensable for locals. After all, the residents of the area, the exact geographical center of the state, also can get the Charlotte, Raleigh, and Greensboro newspapers. “We’ve got to be able to offer a portfolio of products, be able to tell the community stories in different media, and be able to offer our business

community a variety of media to advertise in.”

The *Pilot* even started publishing the phone book 10 years ago, using big print and including community information. “We harnessed the marketing power of the newspaper, marketed the hell out of it, and now we dominate the Yellow Pages,” he says. “We make money on it. A lot of money.” And the newspaper has been on the Web since 1998, but still earns 92 percent of ad revenues from print. Site content is free because they want people to visit for updates, video, and slide shows.

For rural newspapers located in county-seat towns, and that includes the *Pilot*, legal and government notices provide significant revenue. Newspapers are more likely to close in noncounty-seat towns if the retail base dries up because they lack that steady advertising.

As for the quality of community papers — “a lot of them are really good newspapers and a lot of them are not,” Cross says. “A lot of them don’t practice accountability journalism in a meaningful way.”

In that case, the community can always demand a competitor.

Jerry Bellune’s story is unusual. He’s been in the community newspaper business in Lexington, S.C., since the 1980s. When relations with a business partner soured, he and his wife sold their interest, only to have the community beg him to return and start a competitor because they were unhappy with the new paper. He attributes his success with the new paper to its local-issues-only mission (and marketing to the legal community for public notices didn’t hurt either).

Ultimately, he bought his old paper back “for pennies on the dollar” and merged the two. Front page stories one day in January included news about a public hearing to consider a local smoking ban, among others. He says his ad revenue in 2008 fell by 50 percent over 2007, but his circulation of 5,000 is among the fastest-growing in the state. “We like to think we’re a small-town newspaper trying to do good things,” he says.

Talk the Talk

The *Carrboro Citizen* (circulation 5,000) is barely two years old, and its owners might not have heard that print is dead, even though they’re seasoned in the business. The paper grew out of



The Carrboro Citizen in Carrboro, N.C., covers local news for the town of 18,000, adjacent to Chapel Hill, N.C. The free weekly has a history of posting its front pages to its Web site and also updates news via its Web site, blogs, and Facebook.

dissatisfaction with coverage of Carrboro and a University of North Carolina at Chapel Hill class project, an Internet site called “The Carrboro Commons.” A stone’s throw from Chapel Hill, Carrboro (population 18,000) is nevertheless a “very different kind of town,” says editor and co-founder Kirk Ross.

Ross and publisher Robert Dickson met in the class and partnered in the *Citizen* venture. Dickson grew up in the newspaper business. He also owns the Raeford, N.C., *News-Journal*, started by his grandfather in 1905. The Carrboro paper, unlike the Raeford paper, is a free weekly. The circulation revenue for the Raeford newspaper pays for itself and that’s about it, Dickson notes, but in addition to ad revenue, they run legal and public notices. (The *Citizen* is restricted by state law from printing legal notices because it isn’t a subscription paper.)

Despite its fledgling status, the *Citizen* has won first-place awards from the North Carolina Press Association, one in 2009 for a hard-hitting story. “Just because we’re a small

paper, we don’t need to think small,” Ross says. He formerly worked for *The Independent*, an alternative weekly in Chapel Hill, known for investigative work.

He attributes the paper’s success, breaking even, to its language of local. “Almost all the successful community papers had a style, a voice, and felt like a friend,” he says. As big media firms bought small newspapers, they often brought in staff who didn’t “speak the language.” (Of the 180 small papers in North Carolina, more than 100 are owned by 23 media firms, including the New York Times Co., Cox North Carolina Publications, and the Gannett Co.)

The *Citizen*, though it’s a print publication, also has a presence on the Web. “We wanted to be at that party too,” Ross says. If they wanted to keep the status quo, they’d be sitting pretty. But the *Citizen* wants to expand into Chapel Hill. “We’re hearing the same thing from people in Chapel Hill and Pittsboro and Hillsborough — they want their local paper too. The big dailies aren’t covering them anymore.” **RF**

Help Wanted: Business Model for Hard News

BY BETTY JOYCE NASH

The Internet topped all other media except television as the preferred outlet for national and international news for the first time in 2008.

The Internet continues to challenge reliable public affairs coverage in the print world because Web sites like Craigslist, a free classified ad service, has usurped that revenue, formerly a subsidy for hard news coverage. Media and policy experts are looking at ways to save hard news by making the Internet an ally.

Hard news is a public good, expensive to create but cheap to disseminate via the Internet, even if it’s third-hand content originally published by the big papers. And on top of that, there is continued decline in newspaper readership that is fueling “creative destruction” among the big metro daily newspapers, historically the primary news hunter-gatherers of a democratic society. Media analyst John Morton points out that 1,350 of the roughly 1,400 dailies average a circulation of 30,000 and are healthy relative to the papers in large metro areas. The *Rocky Mountain News*, for example, ceased publication in February and the Tribune Co., which owns the *Baltimore Sun*, *Chicago Tribune*, and *Los Angeles Times*, filed for bankruptcy in late 2008. As late as 2003, the average operating profit margin for publicly reporting newspaper companies was about 22 percent, but by early 2008, the margin had fallen to 10 percent, only because of aggressive cost cutting, says Morton.

Historically, newspaper owners, often in monopoly or oligopoly markets, enjoyed power and prestige and were often willing to invest in public affairs coverage out of a sense of civic duty. But consolidation in ownership and the electronic revolution have shrunk sections and report-

ing staffs. Classified ads formerly made up 40 percent to 50 percent of revenues for newspaper firms. The Web site Monster, although it’s suffering now because of the economic downturn, has poached the newspapers’ help-wanted ads.

This kind of disaggregation, in which digital advertising splits from content, hurts newspapers, says Rick Edmonds of the Poynter Institute, a nonprofit school for journalists that owns the *St. Petersburg Times*.

If these publicly owned metros decline or disappear altogether, then who will assume hard news and public affairs coverage? Will fledgling nontraditional press organizations, profit or nonprofit, file Freedom of Information Act (FOIA) requests for access to records? Which groups will devote months to investigations that reveal wrongdoing or ineptitude? What role will private media organizations play?

“The journalism produced by the large newspapers has been greatly diminished,” Morton says, adding that those organizations traditionally cover weighty, nonlocal events that so many in our society depend on, including, by the way, bloggers.

If the “watchdog” and public affairs function is harmed, as shareholder demand drives publishers to serve segments of the population that don’t consume hard news, then that’s a market failure, says economist Jay Hamilton of Duke University. He calls hard news a “tough sell.” People don’t need or want national and international news the way they need facts about the local schools or their property taxes. But they do like knowing what entertainers are up to. So it’s nearly impossible for the detailed reporting that ultimately led to the U.S. Attorney General being forced to resign to create much

of a revenue stream for a media organization.

A ratio of searches to Web sites shows, Hamilton notes, that an audience is more likely to seek information that entertains or helps them make buying decisions than they are to seek out policy details to help make civic choices. These observations about information and democracy predate the Web and were detailed by economists such as Anthony Downs and Mancur Olson.

In general, people remain “rationally ignorant” and it’s not hard to understand why. The odds are slim that one person’s knowledge and subsequent action will influence policy, and so there’s no immediate payoff to learning the nuts and bolts of public affairs. But an immediate gain goes to the reader who finds information that helps buy a decent car at a good price.

As market forces work against hard news coverage today, it’s useful to recall that newspapers in the 19th century were subsidized by political parties because “they were after your vote,” Hamilton says. In the top 50 U.S. cities in 1870, Republican papers represented 54 percent of metro dailies and 43 percent of total circulation in those cities. Thirty-three percent of daily papers were Democratic and held 31 percent of circulation in those cities, according to Hamilton’s book, *All the News That’s Fit to Sell*.

Newspapers shed partisan politics, however, when they needed more subscribers and advertisers. The development of higher-speed (and more expensive) presses, cheap paper, and increased population meant that newspapers could print more copies more quickly and thus reach more readers. They could spread these higher fixed costs across many readers if that increased circulation; advertisers liked the idea, too, because they didn’t have to negotiate ads with multiple papers. Newspapers began to tout independence in political coverage so they could build circulation among readers of all political stripes, and often cut subscription rates to expand audience.

Today, Hamilton says, the biggest market failure is in local investigative reporting “because it’s costly but it’s valuable to the community, but perhaps not highly demanded.”

Alternatives are emerging as nonprofit Web sites proliferate and foundations fund public affairs reporting projects. Nontraditional and nonprofit newsrooms such as ProPublica have popped up on the Web to fill the gaps in watchdog coverage. The nonprofit Voice of San Diego’s mission statement says it “aims to increase civic participation by giving citizens the knowledge and in-depth analysis necessary to become advocates for good government and social progress.” Josh Marshall of the investigative blog Talking Points Memo in 2008 won a coveted journalism

award for reporting on a scandal in which U.S. attorneys may have been dismissed for political reasons.

“The question is how do you maintain the watchdog function of newspapers, not the newspapers themselves, but the function?” asks Hamilton, who also directs the new DeWitt Wallace Center for Media and Democracy at Duke. Possibilities include nonprofit ownership or subsidies to fund expensive investigations. For instance, the Knight Foundation grants money to local foundations to create information about causes they espouse.

An education foundation, for instance, might take up information slack in a city where an education reporter’s position has been cut. Ditto for health care via organizations such as the Kaiser Foundation’s health care news service. The nonprofit Sunlight Foundation since 2006 has funded sites such as OpenCongress and FedSpending, among others.

The DeWitt Center is examining these ideas and more. Complex algorithms, for instance, may ultimately cut the cost of “accountability journalism,” as more local reporters train to investigate public data by this method. That takes data-driven reporting farther and, as more public records go online, may mine information from many sources simultaneously. The Knight Foundation, for instance, has given a million dollars to Everyblock — five people in Chicago who transform government data into neighborhood-specific news on command. You want to know what the City Council of Charlotte, N.C., is considering for your neighborhood? Go to Everyblock and enter your address.

Government may play a role, too, by improving the FOIA process and information infrastructure throughout federal agencies, making data easier to obtain. In addition to nonprofit and government involvement, perhaps critical when maintaining a public good like public affairs coverage, policies such as tax code changes might encourage family or individual media ownership. Hamilton points out in *All the News That’s Fit to Sell* that individuals or families may “identify with the communities ... and try to encourage civic participation through information provision.”

Also under scrutiny is how poor people receive and use information to make choices about payday lending, mortgages, education, and health care.

Still, the big metro papers teeter on the edge of collapse now, and it’s too bad because when it comes to hard news, they are household names, says Morton, the newspaper analyst. They need that advantage. “It’s the brand name and standing that the dailies still have that is going to help them translate to the Internet,” he says. “Cutting back on journalism is going to hamper that effort.” **RF**

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Science Panel May Study Virginia Uranium Plan

BY BETTY JOYCE NASH

Renewed attention to nuclear power has stoked a worldwide rush for the chief constituent of reactor fuel, uranium. Its rising price makes the ore economically feasible to extract, and people are staking claims even on public lands, including the Grand Canyon.

Uranium is a metal that's slightly radioactive, found in rocks, soils, rivers, and seawater as well as in granite, fertilizers, and coal deposits. It's fairly common. But uranium in Virginia? A large deposit of uranium ore — possibly 119 million pounds, if geologists' assessments bear out — lies beneath Pittsylvania County's bucolic pastures.

But in Virginia, there's the small matter of a 1983 state moratorium on uranium mining. State legislators had rejected a uranium mine study, but a Virginia Coal and Energy Commission subcommittee has authorized negotiations with the National Academy of Sciences to study the idea. The stakes are high. The study could clarify long-term effects on air, water, and health. A separate analysis would compare costs to benefits of a domestic uranium supply, jobs, and possibly resource-tax money for the region.

Virginia's Southside

Walter Coles Sr. still remembers the early 1950s when a Geiger counter ticked up in response to what may be the biggest untapped source of uranium in the United States. The signal was so strong that the geologist who brought the device, a friend of his father's, thought it was broken. Nuclear was hot then. President Dwight Eisenhower had pitched "atoms for peace" in a 1953 speech to the United Nations. Nuclear fuel occupied a prominent place in a future of military might and peacetime energy.

Back then, as now, the two families who own the uranium deposits could have sold the land and/or the mineral rights for cash. But they want to mine it "for and by Virginians," Coles says, to shore up the economically depressed region. The deposit lies six miles north of Chatham, Va., a town of stately homes built in more prosperous times, in a region known as Southside. Some of the yards display signs against the uranium mine. Frankly, Southside could use the jobs. The company, Virginia Uranium, estimates those could number 300 to 500, and would include nuclear engineers, as well as heavy equipment operators, among others. The jobs and the possible taxes on the resource could spawn economic development and pay for education and conservation, among other efforts, Coles hopes. About 40 miles away, Babcock & Wilcox and Areva fabricate nuclear fuel, the former for military and the latter for commercial purposes.

Area farmers, according to Coles, often supplement farm income with other employment. Textile and furniture making have eroded, tobacco farming too. "We had raised tobacco until three years ago, since 1785," he remarks on a

drive from the Chatham office to the property. He plants hay for his hobby, 150 head of cattle. Even he left home as a young man because there would not have been enough income to support two families on the farm. He served in Vietnam, and later worked on peacekeeping there, followed by a foreign service career with the State Department, from which he retired in 2004.

Under the property lies a geographical fault, and to the west of it, "two approximately 350 meter long by 250 meter wide ellipsoidal mineral deposits." Those deposits of uranium lie in igneous rocks, hard rocks, but to be used as fuel must be processed to a gas and then further "enriched" into uranium oxide pellets. The ore would likely be excavated in an open pit, using water to damp down the dust. The mill would crush and chemically extract the uranium. The resulting uranium oxide, "yellowcake," would go to a conversion plant such as the one in Metropolis, Ill., and then to the nation's only enrichment plant in Paducah, Ky., before it's in any kind of geophysical shape to fuel reactors.

Contaminated leftover materials and chemicals used in this kind of extraction process typically are collected in retention ponds. The prospect of overflow or failure of impoundments worries the state's biggest environmental group because of Virginia's comparatively rainy climate. Most mines are out West, in arid climates, or in remote regions of Canada. At least one city that gets its drinking water from reservoirs downstream, Virginia Beach, has opposed it.

When the mine closes, the property will be placed in a conservation easement, Coles says. Back on the farm, where the original land grant that bears Thomas Jefferson's signature hangs on the wall of the circa 1817 home, nothing happened after the initial screech of the Geiger counter. In 1979, however, Marline and Union Carbide drilled core samples until 1984 under mineral rights leased from the two families that own the land. The firms back then also leased mineral rights to 16,000 acres in Fauquier, Orange, Culpeper, and Madison counties.

Uranium Supply and Demand

There was even an economic impact study on the possible Coles Hill uranium mine. But demand collapsed and the leases eventually expired in the wake of core meltdowns in 1979 at Three Mile Island, and 1986 at Chernobyl. Cost overruns, nuclear disarmament, and overestimates of electricity demand also killed the 124 nuclear reactors then on the drawing board.

But nuclear's looking, if not hot, then lukewarm. Nuclear reactors don't directly emit carbon. If carbon is priced anytime soon, then nuclear's high capital costs might seem more competitive. Per kilowatt hour, excluding any long-

term waste or capital costs, nuclear generated electricity is cheaper than coal or gas. Nuclear does leave a footprint, though. Worldwide, uranium mines release carbon, processors discharge chlorofluorocarbons, also a greenhouse gas, and then there's that unsolved mystery — waste storage. More nuclear waste repositories such as Nevada's Yucca Mountain would be required if reactors really had to take up the electricity slack.

The Energy Policy Act of 2005 offered investment tax credits and subsidies for construction, among other nuclear perks. That and the industry's longtime federal insurance caps on accident liability have helped propel nuclear energy, and, by extension, uranium prices.

Virginia Uranium estimates its gross revenues at about \$280 million annually depending on uranium prices, which long term are expected to average \$70 per pound. An average mill, says project manager Patrick Wales, is likely to produce around 3.5 million to 4 million pounds a year, for 30 years, roughly.

Back in the mid-1970s, uranium prices reached roughly \$112 per pound, in 2006 dollars. Uranium sold for \$7 a pound in 2002; the price is now about \$42 per pound, down from \$136 a pound in 2007. The \$136 was "due to a lot of investors in this industry looking to buy and hold uranium," says Nick Carter of the Ux Consulting Co. "It's now at a level where, in order for a lot of these new mines to be developed, there needs to be a much higher price."

Production costs help determine viability. "Production costs at Coles Hill are unknown," he says. "The costs typically are higher here than say Kazakhstan and the eastern countries because the regulatory system is much more stringent here than in Asia." Existing mines in Kazakhstan can produce below \$20 per pound, maybe even \$10, he says.

Ux Consulting forecasts uranium prices, but not for the press. "What I can tell you is that over the next couple of years, we see prices moving into the \$50s and \$60s," Carter says. "Beyond that, it's really going to be a function of what new projects come online. We're seeing nuclear growth in Asia, particularly in China and India."

Exploration expenditures in the United States increased 116 percent from 2006 to 2007. Production in the United States reached 4.5 million pounds of uranium oxide in 2007, according to the U.S. Energy Information Administration, about 4 percent of the world total, at six sites in the West. Canada currently produces about 23 percent, Australia about 21 percent, according to the World Nuclear Association. In Africa and Kazakhstan, uranium production is expected to grow to 40 million pounds annually. About 55 percent of the world's nuclear power fuel today comes from uranium, the rest from former military uses. That includes an annual 18 million to 24 million pounds of Russian high-enriched uranium. The agreement that allows this expires in 2013.

On the demand side, several utilities in the Fifth District have plans to build new reactors and many have filed for extensions on existing plants built decades ago. Activity is high in the District because every state except Maryland

regulates utilities. This nonmarket structure lets firms earn a rate of return on investments that can include reactors which ordinary investors might decline to fund. South Carolina Electric and Gas Co., for example, recently got new rates approved for building two reactors. Similarly, Dominion Power customers are already paying, via rate increases, for a coal-fired plant under construction in Wise County, Va.

The Unknown Element

The uranium mine at Coles Hill remains a largely "on paper" enterprise, with operations and output, employment, and other possible effects, good and bad, unknown to the larger community. No current laws address the mining of uranium. The Virginia General Assembly, if it lifted the moratorium, would amend mining laws and draft regulations, according to Mike Abbott of the Virginia Department of Mines, Minerals, and Energy, which regulates coal mines in the state, among other duties. "Our agency would be involved in drafting the language with input from a variety of stakeholders, including the general public."

Once the mine is decommissioned, then the U.S. Nuclear Regulatory Commission specifies how the tailings, or waste, are to be managed. How water flows through rock may affect that. From 1911 through the 1950s, a Canonsburg, Pa., site was inappropriately mined, but remediated by the government in the 1980s. While there were no milling-related traces in the surface waters of the nearby creek, the groundwater remains contaminated. Both surface and ground waters will be monitored in perpetuity, according to the Energy Information Administration. Mines in remote Canadian locations, however, could prove similar in geology and hydrology to Virginia, according to Virginia Uranium.

Because this hard rock mine is breaking new ground, the Piedmont Environmental Council has requested that Virginia sponsor original research. "The first thing to do is study those areas comparable to Virginia — rainfall, geology, hydrology — to see if it's ever been done properly," says Todd Benson, a council attorney. "Show us five places where it's been done comparably."

Virginia Uranium has offered to help pay for any study. Meanwhile, the firm's parent has sold an 8 percent stake to a Canadian resource firm, Santoy, to raise cash, and plans to go public in Canada first. The United States has been out of the uranium mining business since the price collapsed, and Coles notes that there's little mining expertise left on Wall Street.

Benson, for now, wants to make sure the study is sound. "It appears the best possible study will require you do in-the-field research," he says, because of Virginia's rainfall compared to the arid West. Waste lagoons could overflow in a heavy rain event, and inaccurate predictions would mean trouble. "Let's look at where it's been done — has it been done anywhere comparable to Virginia? If it's never been mined anywhere similar to Virginia, then at least we know we're in uncharted territory." **RF**



Regency Furniture Stadium — Waldorf, Md.



Fluor Field at the West End — Greenville, S.C.

Ballpark Boom

New minor league stadiums spring up across the region

BY DAVID VAN DEN BERG

Minor League Baseball gives the game's future professional stars and some colorful characters the chance to perform in large and small cities around the Fifth District. So it may be no surprise that the District has experienced a boom in minor league stadium construction over the past few years.

The minor league teams market themselves as affordable entertainment for families. The pitch has proved successful, as more than 43 million fans attended games throughout Minor League Baseball during the 2008 season. Minor league teams are big business. Class AAA teams are valued starting at \$15 million, while class AA teams are valued starting at \$10 million, says Steve Densa, a spokesman for Minor League Baseball.

Teams operate in large and small cities at the Class AAA, AA, A, and Rookie league levels. In Class AAA, the highest level of Minor League Baseball, teams compete in three leagues: the Pacific Coast League, the International League, and the Mexican League. Teams in the Pacific Coast and International leagues have player development relationships with Major League Baseball clubs.

Of the 30 teams in the International and Pacific Coast leagues, 14 play in metropolitan areas that have at least one franchise in either Major League Baseball, the National Football League, the National Basketball Association, or the National Hockey League. Seven of those teams play in regions that have two or more franchises with teams in the four major professional leagues.

The Charlotte Knights, one of those seven minor league teams, are the Chicago White Sox's Class AAA team. They currently play in Charlotte's South Carolina suburbs but plan to move into the heart of the city.

Charlotte houses the National Football League's Panthers and the National Basketball Association's Bobcats. Smith College economics professor Andrew Zimbalist says he doesn't think the Knights compete much for fans with

the Panthers and Bobcats because the seasons don't overlap. However, that doesn't mean there's no competition among the teams at all. "What they do potentially compete over is corporate sponsorship dollars," he says.

There are cases of minor league teams at the Class AAA, AA, and A levels that play in regions with Major League Baseball teams. Liberty Media, owner of the Atlanta Braves and all but one of its minor league affiliates, has moved the Braves' AAA farm team from Richmond, Va., to Gwinnett County in suburban Atlanta. The former Richmond Braves are now the Gwinnett Braves. In Class AA, the Texas Rangers' affiliate plays in Frisco, a Dallas suburb. In Class A, the San Jose Giants are a farm team for the San Francisco Giants, while the Potomac Nationals, an affiliate of the Washington Nationals, play in Woodbridge, Va., a D.C. suburb.

The major league affiliation of minor league teams doesn't matter much to fans. "I think a lot of the fans from one year to the next are not necessarily sensitive to who the affiliate is," says Stan Brand, vice president of Minor League Baseball.

Major league teams can benefit from having their farm teams closer to home. Cross-promotional activities can occur when major and minor league teams are close together, Brand explains. Major league teams may be able to reduce personnel costs like training staff when their minor league affiliates are in the same metropolitan area, says J.C. Bradbury, an economist and health, physical education, and sports science professor at Kennesaw State University in Georgia.

To a certain extent, Minor League Baseball teams choose locations for the same reasons Major League Baseball teams do, says Bruce Johnson, an economics professor at Centre College in Danville, Ky. They want to be in the largest markets possible because that's where they can make the most money. The decisions local governments make about build-

PHOTOGRAPHY: CHE DOWNS; BILLY CROWE/GREENVILLE DRIVE

ing and financing stadiums also factor into the equation.

Player development contracts govern the relationship between major league teams and their minor league affiliates. The contracts last two or four years. For the 2009 season, six teams at the class AAA level will have new major league parent clubs.

Minor league teams are subject to territorial rules, which creates opportunities for independent leagues, says Chris Allen, general manager of the Southern Maryland Blue Crabs in Waldorf, Md. There are seven independent leagues with teams in Mexico, Canada, and the United States. Many teams already play in suburban or exurban sections of regions with major league franchises, like the Atlantic League's Blue Crabs. "Minor League Baseball has to overlook a lot of great markets," he says.

Unlike affiliated teams, independent league teams have to pay their own players. The added expenses require teams like the Blue Crabs to be more careful in their calculations and projections, Allen says. The team follows a grassroots advertising approach as well. To attract fans, the team attends county fairs and similar events, and has their mascot stand on the corner by the stadium on game days with a sign touting that night's game.

The Professional Baseball Agreement governs the relationship between Major and Minor League Baseball. The first contract took effect in 1901, and the current version expires in 2014. Under the agreement, major league teams cover player payrolls for their minor league affiliates. Major league teams and their affiliates share some operating costs like bats and balls, Densa says. The minor league teams pay a ticket tax to Major League Baseball based on an attendance formula.

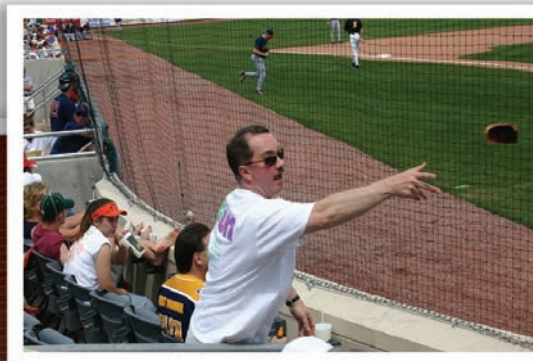
When the two sides negotiated the agreement in December 1990 that took effect in 1991, it included new requirements for minor league ballparks, including recommended seating capacities for stadiums at each classification, Brand says. The suggested seating capacity for Class AAA stadiums is at least 10,000 seats. One hundred nine teams have opened new stadiums since 1991, with seven more slated to open this year. "It's a much more pleasant experience for the fan than it probably was in 1991," Brand says.

If You Build It, What Will Come?

During Greensboro Grasshoppers games at NewBridge Bank Park, the team president's dog, "Miss Babe Ruth," delivers balls to the umpire and, on Thursday nights, fans gather for "Thirsty Thursdays" when beer costs as little as a dollar.



NewBridge Bank Park — Greensboro, N.C.



The "toast man," an avid fan at Appalachian Power Park — Charleston, W.Va.

Greensboro, N.C., is one of four cities in the Fifth District that has opened new minor league ballparks since 2005. NewBridge Bank Park has proven wildly successful for the Grasshoppers. More than 400,000 fans jammed the stadium in each of its four seasons. In its December 15 issue, *Baseball America* honored the team with its Bob Freitas award, which recognizes outstanding operations at each level of Minor League Baseball. "They've just knocked the lights out for four years in a row," says former Greensboro mayor Jim Melvin.

While the Grasshoppers have packed fans into their ballpark, it hasn't spurred much nearby development. Some adjacent properties are vacant, including the site of a former Chevrolet dealership. Donald Moore, the team's president and general manager, called the lack of development immediately around the stadium the sole disappointment for him since the ballpark opened, but said the downtown area itself has grown. "Six to eight years ago, on a weekend night, the last place you would ever think about going would be downtown Greensboro," he says.

Growth has come downtown, including a city park, with more planned. At the site of the F.W. Woolworth Building, work has started on the International Civil Rights Center & Museum. That's where four students from what's now known as North Carolina A&T University staged a 1960 sit-in that proved integral to the civil rights movement. Residents should have started moving into Center Pointe, a condominium development located in a former Wachovia office tower, says Roy Carroll, president of The Carroll Companies, the developer of the complex.

Major development has been proposed adjacent to the stadium. Steve and Jim Jones, whose family owns the now-vacant Chevrolet dealership, proposed a \$60 million to \$100 million complex called Bellemeade Village, according to a Greensboro *News & Record* report in May. The development would have included shops, offices, condos, and apartments. The brothers backed away from their plans in 2006.

Carroll said he has an option on that land now and owns other parcels adjacent to the stadium. He's planning 200 luxury apartments on most of the car dealer site, and retail on the remainder. That project will start once "banks decide to start lending money again," he says. Residential and

retail are planned for the other parcels he owns.

Residential and retail space are two of the “three Rs” of downtown development, with the other being restaurants, says Andrew Brod, director of the Center for Business and Economic Research at the University of North Carolina-Greensboro. The city had downtown restaurants before the stadium opened, but retail and residential space have been slow in coming to the city. Greensboro is a “city of suburban neighborhoods,” Brod says. “I don’t think it’s easy to attract business downtown.”

NewBridge Bank Park has been open for four seasons. David Hoggard, a member of the city’s parks and recreation commission and an opponent of the project who wanted the team’s previous ballpark renovated instead, says development’s been slow because “it’s a ballpark.”

“You would think the building would have happened during the excitement,” he adds. “Ballparks don’t spur anything.”

While Greensboro’s ballpark was built as a freestanding project, two other District cities plan to include their stadiums as part of larger developments. Construction has started on a ballpark in Winston-Salem, N.C., which will have mixed-use development attached. It had been expected to open at the start of the 2009 season but faces delays, according to a *Winston-Salem Journal* report. That’s because Billy Prim, an owner of the minor league Winston-Salem Dash, is negotiating to buy out his business partner.

The second phase of the project will turn adjoining land into a mix of uses, including offices and retail. Prim controls about 35 acres of land next to the ballpark. Including the stadium, the entire development is expected to cost about \$189 million. The city is contributing about \$12 million to the stadium, \$5.5 million of which came from the sale of the team’s prior home to Wake Forest University. Additional incentives will go to the development around the stadium.

Derwick Paige, a deputy city manager in Winston-Salem, says his city learned from Greensboro. It’s important that the ballpark developer control the land around it, he says. “I don’t think [the city] would have been involved were it not for phase two,” he says.

In Richmond, a developer is proposing a more than \$318 million complex in the Shockoe Bottom neighborhood east of downtown. The development would include a ballpark, retail, offices, and residential space. Taxes the project generates would be diverted to pay off the stadium construction cost.

Winston-Salem and Richmond are following a path Cleveland State University urban affairs professor and sports economist Mark Rosentraub advocates. “In more cases, these mixed-use developments have produced success,” he says. Rosentraub assisted on the Petco Park project in San Diego, which delivered a new stadium for Major League Baseball’s San Diego Padres and development around it. He cites another successful example of this approach: the Arena

District in Columbus, Ohio, where the National Hockey League’s Columbus Blue Jackets and the Class AAA Columbus Clippers baseball team play. “A sports facility is a very large capital asset,” Rosentraub says. “No one would buy or place a large capital asset in a specific location without a strategy.”

There are other ways to develop downtown areas than by stadiums, says Dennis Coates, an economics professor at the University of Maryland, Baltimore County. He mentioned a Habitat for Humanity development in downtown Baltimore, which has seen baseball and football stadiums constructed since 1992. “I think that revitalizes the neighborhood far better and at far less taxpayer expense,” he says.

There are numerous examples where promises about stadium-related development weren’t met, Coates says. And, he adds, that even if it’s done effectively, it isn’t clear that building a stadium is the right thing to do. “Wouldn’t it be better to have something anchoring development used 365 days a year?”

Typically, stadium advocates approach debates about subsidies by saying the venue will generate tax revenues and create new jobs, Coates says. There’s no evidence any of that happens, but that doesn’t mean the ideal stadium subsidy is necessarily zero. “What determines the effectiveness of the subsidies is whether the return on the subsidy is greater than the opportunity cost,” he says.

While Minor League Baseball has opened more than 100 stadiums since 1991, the big leagues have experienced a ballpark boom too. Since 1990, Major League Baseball — which has 30 teams — has opened 19 new ballparks. In the same time period, 17 National Football League teams started playing in new stadiums, and more than two-thirds of National Basketball Association teams moved into new arenas, according to an April 2008 article by Coates.

Over the last 20 years, the public has covered an average of 65 percent to 70 percent of major league stadium costs, Zimbalist of Smith College says. “The typical situation involves a lot of one-sided and exploitative arrangements,” he said. And the economic arguments against public investments in minor league stadiums are similar to those for major league stadiums. “The same general conclusion holds, which is a positive economic impact should not be anticipated,” he says.

Cities like Greensboro that have constructed minor league ballparks have done so in a volatile climate. Since the new stadium rules took effect, 93 of the 176 minor league baseball teams that charge admission for their games have relocated, compared to one major league team since 1973.

“Obviously movement is somewhat more frequent,” Brand says. “My guess is that over the last almost two decades, we’ve probably renovated or built 100 stadiums and spent jointly with our communities in excess of a billion dollars on these facilities.”

Richmond officials, who saw the Braves move, say the number of team relocations in minor league baseball doesn’t concern them when it comes to bringing a team back. “This

is going to be a locally owned team versus some outside major corporation,” says Carthan Currin III, the city’s economic development director.

Baseball is a key part of the city’s history, Currin says. A Richmond-led investor group hopes to bring a team back. If they do, the team will have to play temporarily in The Diamond. In the end, the stadium wasn’t a good enough home for baseball, Currin says. Attendance dropped at Richmond Braves games during the team’s final 10 seasons there. In the 2006 and 2007 seasons, the team averaged more than 330,000 fans, while the 2008 season drew about 290,000 fans. The 1999 season was the only one of the final 10 in which more than 500,000 fans attended games, according to Minor League Baseball figures.

Current plans call for the city of Richmond to donate about 11 acres of land for the potential new stadium in the Shockoe Bottom area. The city would also cover about \$8 million in infrastructure costs like utility relocations, says Peter Boisseau, a spokesman for the project. Revenues generated at the ballpark and the private development around it would be used to pay off the bonds. A deal hasn’t been reached on the ballpark project, but Currin says the city would not be on the hook for the bonds.

Shockoe Bottom is a great location for the stadium because of the restaurants around it, says David Wilkins, senior vice president with CB Richard Ellis in Richmond. If the city wants land redeveloped, it has to participate. “Without providing the land to the developer, in this environment, it would not be a viable project in my opinion,” he says.

To help make the Greensboro ballpark a reality, the Bryan Foundation acquired land for and constructed a 120,000-square-foot building for Guilford County’s social services offices. In exchange for the \$9.5 million building, the county traded the land the ballpark was ultimately built on and paid the foundation \$4.5 million, Melvin says.

The foundation borrowed \$10 million for the ballpark, and the team pays \$1.2 million a year in rent to service the loan. The team can buy the stadium at any time for what the foundation has invested in it. Moore says the team plans to do that within five years.

In South Carolina, the Greenville Drive ownership funded construction of its stadium and have paid for improvements to it since then, says Nancy Whitworth, the city’s economic development director. The city did buy the land for the ballpark from the school district and paid for some “streetscape” improvements to the property. The team makes a small lease payment to the city.

Fluor Field at the West End, Greenville’s ballpark, opened in 2006. The Drive is a Class A Boston Red Sox farm team. The community has responded favorably to the new team and stadium. According to the Drive’s Web site, the team averaged 4,784 fans a night in 2006, an increase of 178 percent from 2005. Development, including condos and restaurants, has sprouted around the ballpark too. “We’ve been trying to work toward the revitalization of this area

for 15 years at least,” Whitworth says.

Charleston, W.Va., and Waldorf, Md., joined Greenville and Greensboro as Fifth District cities to have opened minor league ballparks since 2005. In Charleston and Waldorf, local and state governments invested more directly in ballparks. The state of West Virginia provided about \$12 million of the more than \$20 million ballpark cost through a state economic development grant. Revenues from the legalization of video lottery machines funded the grant program. The Southern Maryland Blue Crabs, who play in the new Regency Furniture Stadium in Waldorf, paid a third of the ballpark’s \$26 million cost there, says Gary Hodge, a Charles County, Md., commissioner who supported the project. From day one, he said the ballpark was designed as a quality of life addition for the community. “We didn’t build this to make money,” he says. “The communal experience in the stadium was one of the best things the county has ever offered the public.”

Television and the Toast Man: Noneconomic Benefits of Stadiums

Sports teams represent a socially consumed commodity, writes University of Chicago economist Allen Sanderson, in “In Defense of Sports Stadiums, Ballparks and Arenas,” an article published in the *Marquette Sports Law Journal*.

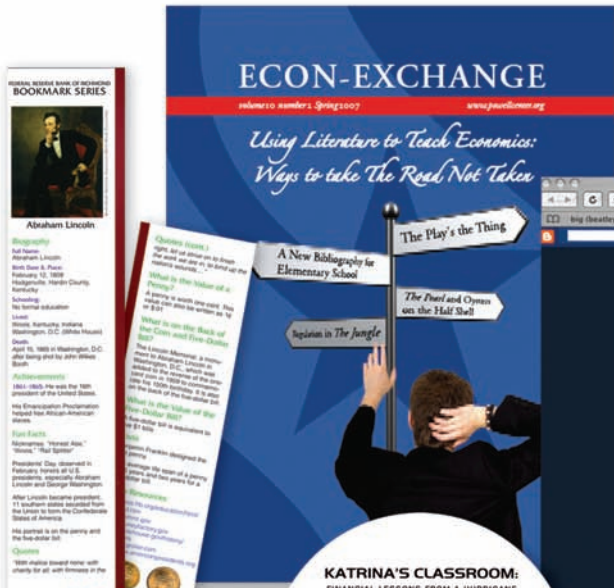
Even if die-hard fans do not attend games, they can watch games on television, hear them on the radio, read about them, and discuss the team and its players with friends and co-workers. Sports, perhaps like recycling programs, could be considered an activity that does not pass benefit-costs tests on direct scrutiny but is socially efficient in a broader context, Sanderson writes.

“I would give stadium advocates more credit if they went down that line of argument,” says Frank Stephenson, an economics professor at Berry College in Georgia. “There’s some element of civic culture that comes with having a local sports team.” Stephenson adds that those benefits are likely smaller at the minor league level.

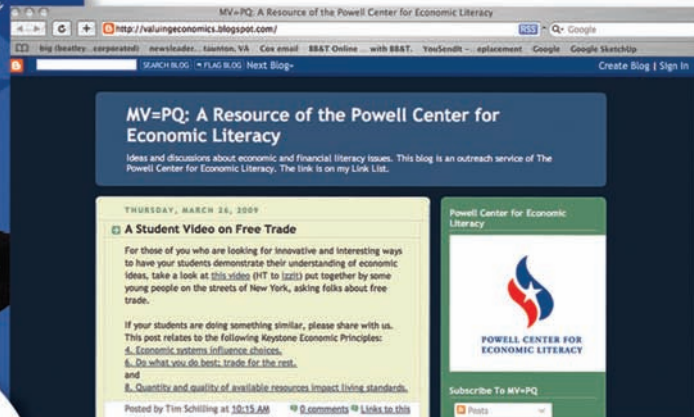
Economic research, using contingent value methods, has been conducted to try to measure these benefits. Bruce Johnson of Centre College in Kentucky has done some of that research. He worked with an economist to determine what people in Lexington, Ky., would pay for a new arena for the University of Kentucky basketball team and for a new minor league baseball stadium. For the basketball arena, community residents were asked about their attendance of Kentucky Wildcats basketball games, their fan loyalty, and the highest amount they would take out of their household budget to make the arena possible. Questions about the baseball stadium included the number of games the residents expected to attend, and whether they would support higher taxes to fund the ballpark.

“Whatever willingness there was to pay was almost entirely due to their interest in going to games,” Johnson says. “It’s not to say Minor League Baseball isn’t fun and a nice

continued on page 46



Resources like these are incorporated into high school curricula and teacher workshops throughout the educational system.



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Courtesy of the Powell Center for Economic Literacy, Federal Reserve System, and Virginia Council on Economic Education.

The economics behind high school economic education

BY RENEE COURTOIS

A group of analysts studies the S&P 500 as it plunges 100 points. Stocks have been tanking for days, so tensions among many are mounting. Others are guardedly optimistic that a bottom to the decline may be near. By the end of the trading period, the exhausted parties retreat to their desks to recap the trading day and discuss strategy before next session's opening bell.

These analysts are not stockbrokers; they are 12th-grade high school students gaining their first introduction to investing and personal finance through an online stock market simulation. The class session is part of an effort to teach students economic concepts by immersing them in real-

world scenarios instead of traditional lectures and graphs. How do students like it?

"Due to the success of the program, the class size has expanded from 85 students last year to 180 this year," says Tim Hudenburg, social studies teacher at Oakton High School in Vienna, Va.

Stock market simulations are just one way in which economics teachers try to blend economic theory with real-world application, and this is a scene you might find in any number of classrooms across the country. About 50 percent of high school graduates nationally take an economics course in high school, up from 24 percent of students in the

early 1980s. This is due in part to the push in recent years toward adding economics courses as a high school graduation requirement (see chart on page 31).

The primary motivation for educating individuals about economics and personal finance is fairly straightforward: Economic and financial decisions pervade our everyday lives. Yet, the concepts involved are not always intuitive and are often downright complicated.

Adults face a variety of significant financial choices: what current and future job opportunities to pursue, where to live, whether (and when) to purchase a home, what financial assets to invest in, and how much to save for retirement or pass down to their children. Despite the fact that people have an incentive to educate themselves about such financial decisions, occasional missteps do occur. These range from behavior that is simply hard to reconcile with standard economic theory — such as underparticipation in employee-matching 401(k) plans or bypassing advantageous mortgage refinancing opportunities — to more serious financial mistakes that result in loan delinquency or bankruptcy. Highly targeted financial education initiatives have been shown to help adults make better financial decisions.

Clearly, high school students don't make financial decisions of the same magnitude as adults. They typically are not in the market to purchase homes and most don't even have credit cards. However, many do face choices about jobs, how to create and follow a budget, and how to save for college or some other goal. They will most certainly face more complicated financial decisions as college students and adults.

High schoolers also are a captive audience. Economist William Walstad of the University of Nebraska-Lincoln estimated that high school is the last opportunity for 75 percent of people to ever formally study economics — either because they don't go to college or because only 40 percent elect to take an economics course if they do go to college. Together, these factors provide considerable rationale for targeting educational initiatives in economics and personal finance toward high schoolers.

Experience-based teaching methods like stock market simulations have proven particularly effective at the high school level. Still, quality education in economics and personal finance faces tough challenges, including inconsistent requirements for graduation across the country, trade-offs between teaching economics versus personal finance and how to effectively make them complements, and the lack of research studies to determine which types of programs work best at this level of education.

The Lay of the Land

Even in states where schools are required to offer courses on economics or personal finance, students may not be required to take them. Similarly, despite the large number of states that have established content standards for economics and personal finance, the number of states requiring students to take the courses for graduation is dramatically lower. As of the latest count in 2007 by the Council for

Economic Education (CEE), 17 states require students to take economics before graduation, while only seven states require personal finance.

Within the Richmond Fed's district, only the Carolinas require students to take an economics course prior to graduation, and no Fifth District state requires students to take a course devoted to personal finance (see chart below). This is not for lack of trying. In Virginia, for example, the state CEE along with the local chapter of the Jump\$Start Coalition for Personal Financial Literacy recently encouraged the Virginia Board of Education to insert into state graduation requirements a joint course on economics and personal finance. The provision was passed in February 2009, and it will go into effect starting with students entering 9th grade in 2010.

One of the main reasons that all states do not adopt requirements in economics and personal finance is the trade-offs entailed. For every economic concept a teacher covers, a topic in another discipline is not. According to a survey of teachers by Networks Financial Institute at Indiana State University, the lack of time, state curricula requirements, and demand are the three greatest challenges to teaching financial literacy topics, according to K-12 teachers. Teachers also say that they are not sure where to even fit financial literacy into curricula in which it is not already required.

Schools are more likely to offer courses in economics and personal finance if they have faculty available who are trained in these fields. Indeed, another institutional challenge of this type of education has to do with the qualification of teachers, a major determinant of how well economics and personal financial are taught. A 1999 paper by Walstad and Sam Allgood, another University of Nebraska-Lincoln economist, argues that teachers need at least six college-level courses before being qualified to teach economics effectively — the paper claims that most high school economics teachers, in actuality, take one or two economics courses in college. To address this issue, many

	ECONOMICS		PERSONAL FINANCE	
	REQUIRED FOR HIGH SCHOOL GRADUATION	IMPLEMENTATION OF STATE CONTENT STANDARDS IS REQUIRED *	REQUIRED FOR HIGH SCHOOL GRADUATION	IMPLEMENTATION OF STATE CONTENT STANDARDS IS REQUIRED *
DC		✓		✓
WV		✓		✓
MD		✓		
VA		✓		✓
NC	✓	✓		✓
SC	✓	✓		✓

NOTE: *Content standards for the subject have been developed within the state, and are required to be implemented (used) by schools. In Maryland, no content standards have been developed for personal finance.

SOURCE: "Survey of the States: Economic, Personal Finance & Entrepreneurship Education in Our Nation's Schools in 2007," Council for Economic Education, 2007

nonprofit organizations with an emphasis on economic and financial education focus their efforts on teaching teachers. Organizations such as the CEE, Jump\$tart, and Federal Reserve banks are primary contributors in this area, offering an extensive supply of curricular materials and teacher workshops. The CEE and Jump\$tart also get involved in influencing content standards in states, as with the recent push in Virginia.

One question raised by the gaps in state requirements and teacher expertise is whether financial literacy is something better left to parents to teach their children. Whether this is true may depend on who you are. Students who score poorly on economic and financial literacy surveys are more

likely to be from households that are either lower in income or educational attainment, or both. Students of those backgrounds also are less likely to go to college and, consequently, are likely to earn less as adults.

These findings seem to imply that students who are the least likely to learn personal finance fundamentals at home are those who need that sort of training most at the high school level. Lacking are studies that investigate the cause of correlations between a student's socioeconomic standing and their economic and financial literacy. Regardless, it is likely true in at least some instances that students cannot learn at home what their parents themselves do not understand.

How Well Do Economists Understand Economics?

Could you answer this question?

You won a free ticket to see an Eric Clapton concert (which has no resale value). Bob Dylan is performing on the same night and is your next-best alternative activity. Tickets to see Dylan cost \$40. On any given day, you would be willing to pay up to \$50 to see him. Assume there are no other costs of seeing either performer. Based on this information, what is the opportunity cost of seeing Eric Clapton?

- A) \$0
- B) \$10
- C) \$40
- D) \$50

A survey of 199 Ph.D.-level economists made headlines in 2005 when, apparently, nearly 80 percent of them answered incorrectly. Two-thirds of them had an average of about 15 years post-Ph.D. experience, with the rest being Ph.D. candidates, and almost half got their degrees from a top-30 institution. Sixty-one percent of all respondents had taught introductory economics.

Opportunity cost, as economists call it, is what you give up in order to get something else. Put differently, opportunity cost is the value of your next-best alternative. It is one of the most fundamental economics concepts there is, and underlies all economic assumptions about how people make decisions. Understanding your opportunity cost is, in theory, the means by which you decide if a given opportunity is worthwhile.

In the question above, the correct answer is B: The opportunity cost of seeing Eric Clapton is \$10. You value the Dylan concert at \$50 but you would have to pay only \$40 to go, so your net benefit from seeing Dylan would be \$10. However, you forego the option to see Dylan, so you're giving up the equivalent of \$10 if you choose to see Clapton after all.

It turns out that the correct answer was the least popular of the economists surveyed, chosen by just 21.6 percent.

The most popular answer was \$50, which 27.6 percent chose; 25.6 percent chose \$40, and 25.1 percent chose \$0. In other words, economists' performance on this question was similar to the likely performance of kindergartners on the same question: Choosing an answer at random would have yielded a similar result.

Before we start to lament the state of the economics profession, a closer look at the question is in order. Those who thought the opportunity cost was \$50 may have believed that only the benefit received of attending the Dylan concert was relevant, ignoring the cost of purchasing the Dylan ticket. Those who chose \$40 seemed to focus on the word "cost," confusing opportunity cost with the dollar cost of seeing Dylan. Those who chose \$0 may have misread the question, thinking they were being asked to guess the opportunity cost of seeing Dylan (which would be nothing, since the Clapton ticket was free and the question implies you don't place any value on seeing old Slowhand).

These answers are still incorrect, but at least they are justifiable. Many economists who answered the question incorrectly probably either read too much into the question or found the wording to be confusing.

Economic literacy tests like the U.S. Department of Education's National Assessment of Educational Progress seek to separate jargon from basic concepts, attempting to evaluate comprehension of the underlying idea over memorization. Based on the survey of economists, this is a good thing. For the use of economics in the real world, it is less important that students can define the phrase "opportunity cost," and more important that they understand that people make decisions based on their perceptions of the next-best alternative.

By the survey's own admission, this study was casual and extremely narrow. But it highlights a challenge in assessing economic literacy at any level: Even when seemingly straightforward, assessment is extremely difficult — and survey design is key.

— RENEE COURTOIS

Economics and Personal Finance: Complements or Substitutes?

How is economics different from personal finance? One might think of economics courses as developing the intuition behind how markets and economies work, while personal finance provides a more applied understanding of some of the financial decisions currently face and will continue to face in increasing complexity in adulthood.

In practice, high school personal finance typically encompasses the fundamentals of saving and investing, budgeting, and debt — concepts that might help transition students from being under their parents' financial wing to managing their own finances. Its focus tends to be on the practical application of skills within real-world situations that students are likely to face.

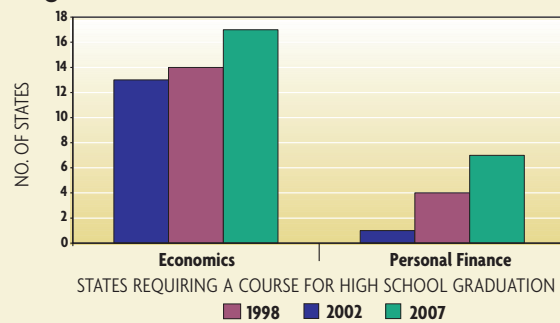
High school economics, on the other hand, can take one of two approaches. Some economics courses focus on economic theory: fundamental topics such as scarcity, the determination of prices through supply and demand, and the concept of comparative advantage. Other economics courses are more applied and often linked to civics, covering the roles of government, taxation, and comparative economic systems in societies. Rarely do high school economics courses cover the more nuanced fields of economics such as game theory and behavioral economics, but even the basic economic principles taught at the high school level can provide the foundation for students to utilize economics as a framework for understanding both the financial and nonfinancial world.

Both economics and personal finance reinforce an understanding of how the economy and world operate, so naturally there is considerable crossover between the two. However, there is no consensus among states, or even school districts within a state, on whether economics and personal finance concepts should be taught together or in completely separate courses.

This is a shame, according to some who view the two as complements. Kurt Waters, a high school social studies specialist for Virginia's Fairfax County Public Schools, says that teachers who segregate personal finance from economics miss a unique opportunity for students to recognize their own patterns of behavior in microeconomic theories about how people and firms make choices. For them, the juxtaposition of economic theory and the application offered by personal finance can firmly ground these concepts as well as create an appetite to learn more. "For kids who study theory first, it can go in one ear and out the other. Bright kids will soak up anything, but most kids need relevance to be able to understand theory. They need to see it played out in reality, and that makes it exciting to them," Waters says. "In my experience, it is tremendously successful to hook them with personal finance, and then weave economic theory throughout."

Tim Schilling, associate director of the Richmond-based Powell Center for Economic Literacy, believes that comprehension of both economics and personal finance is critical

Push Toward Personal Finance Lags Economic Education



SOURCE: "Survey of the States: Economic, Personal Finance & Entrepreneurship Education in Our Nation's Schools in 2007," Council for Economic Education, 2007

because an understanding of how personal finance decisions play out in the macroeconomy can help students understand how aggregate outcomes can affect them personally. "I think understanding economic principles is a vital component to being financially literate. Understanding how economics makes the larger picture work is important in making personal financial choices. Many people don't understand the concept of debt as a tool in the overall economy, much less the macroeconomic implications of defaulting on loans," Schilling says.

Assessment Is Key

There are several goals of economic and financial education at the high school level, including better preparation for financial independence in college, better performance in college economics courses, and producing more informed voters. Ultimately, however, better financial decisionmaking is largely touted as the primary goal. Unfortunately, research is notably lacking in whether this is actually achieved.

By one measure, high school seniors' financial literacy has never been worse. The biannual JumpStart Coalition's 2008 Survey of Personal Financial Literacy Among High School Students produced the lowest financial literacy scores of high school seniors since the survey was first conducted in 1997, with high school seniors' average literacy falling to 48.3 percent. The students were tested in classes unrelated to business, economics or personal finance, so we cannot link this performance to the quality of in-class instruction or to the quantity of related classes taken by students. In other words, the survey simply assesses high school seniors' literacy of personal finance issues, not the effectiveness of education geared toward it.

The U.S. Department of Education's first-ever National Assessment of Educational Progress (NAEP) in economics may present a rosier picture, at least at first glance. This 2006 assessment found that 79 percent of high school students possess at least a "basic" understanding of economics. The NAEP survey is carefully designed to assess comprehension of the fundamental concepts in macroeconomics, microeconomics, and international economics — as opposed to the jargon and algebraic properties that can

saturate the field — whether students learned the concepts in school, at home, or elsewhere. While the vast majority of these students (87 percent) had studied economics in some form in high school, their performance on the NAEP cannot be tied to one specific course or method for teaching economics. Researchers will be able to better interpret these results in the next NAEP study on economics in 2012.

The NAEP and Jump\$tart surveys were not designed to be directly comparable, so we cannot draw conclusions on the state of economics education relative to personal finance based on these separate assessments. For example, since the NAEP test focuses on underlying economics concepts instead of definitions, it may be easier for students to reason through even without concrete, or quality, economics training. The Jump\$tart personal finance literacy survey, which can cover investment vehicles, the tax treatment of savings, and stylized facts on investing, may be thought to require more direct instruction and retention of definitions in order for students to perform well. These disparities highlight that survey design is a major determinant of results on tests of economic and financial literacy.

There is an even greater challenge on assessing the efficacy of economic and financial education. Despite the best of performances on economics and financial literacy tests, there is no guarantee that students will go on to apply those concepts later in life. Financial decisionmaking and its outcomes occur far outside the classroom, long after classes have been taken. This means that studies which look at the effectiveness of economic and financial literacy must connect learning experiences in high school with the financial decisions made years later.

Longitudinal studies that follow individuals over time run into a classic problem which high school economics students are warned about: the trap of confusing correlation with causation. It may be that those who study financial topics in high school and go on to make sound financial decisions are simply better at it to begin with. Researchers can attempt to correct for this by accounting for factors such as I.Q. or SAT performance, which have proven to correlate with economic and financial literacy. However, they cannot capture the intrinsic willingness of some individuals to engage in financial markets, adapt from past experiences, and make themselves aware of new opportunities. In those cases, financial education initiatives may not be the primary drivers of behavior.

Schilling agrees that there is something inherent about economics and financial education programs that makes

their assessment difficult. “We sometimes forget that there are motivational factors beyond the financial that affect decisions — time, emotions, self-satisfaction, etc. I’m not sure you can capture that on a standard study.”

Forward Looking

Some conclusions can be drawn from studies on adult financial literacy about what educators could emphasize at the high school level. First, successful programs for adults are highly targeted and event driven: for example, homeownership counseling for adults about to purchase a home or precrisis counseling programs for those making a major refinancing decision are the most effective. Second, programs for adults tend to focus on their biggest financial risk areas: debt management, mortgage counseling, and retirement planning.

How would this be mimicked at the high school level? From a personal finance perspective, education could be targeted toward the benefits and pitfalls of credit cards, the basics of budgeting, and how students can form realistic expectations for their financial future. It would also be helpful to provide students with an understanding that individuals bear responsibility for their financial health. For example, it is not the job of credit card companies to see to it that individuals manage their debt — people must check and manage their credit reports, and fraud can hit even careful consumers. From an economics standpoint, students need to understand how to apply basic microeconomic reasoning to major decisions: Start with a cost-benefit analysis, add incremental degrees of complexity, and keep aware of unintended consequences. They also need a grasp of how their financial decisions interact with the broader macroeconomy.

We also know that experience-based activities which are fun and involve real-world problem solving, such as popular stock market simulations, may give students the most encouragement to absorb and retain information. Importantly, more assessment is needed on the effectiveness of specific education initiatives at the high school level.

But who says tests of economic understanding aren’t associated with changed behavior? Hudenberg’s stock market simulation exercise may have stumbled onto one surefire method for getting students to absorb the economic and financial information they’re learning. “The overall winner of the stock market game does not need to take the final in June, which has given the students some real incentive to succeed,” the teacher says. **RF**

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Housing Cools State-to-State Migration

But Carolinas remain a magnet

BY BETTY JOYCE NASH

People aren't moving much these days, but that has only slowed, not stopped, the tide of migrants, return migrants, and retirees to North and South Carolina. Those were among the top 10 fastest-growing states last year, continuing a longstanding trend broken only by recessionary dips.

Year-over-year U.S. Census Bureau estimates cover changes from July 1, 2007, to July 1, 2008. The numbers capture the effects of current events, according to demographer William Frey of the Brookings Institution. "A whole number of southeastern and inter-mountain western states showed lower growth last year, and even two years ago compared to the middle part of the decade due to the inability of people to get credit and mortgages," he says. Frey notes that past recessions were more job or industry related but the housing crisis has had a lot to do with it this time. "The fast-growing states are not attracting as many, and slow-growing states are retaining more population because people aren't moving," Frey notes. Collapsing home values have cut back on peoples' ability to sell homes in preparation for a move, and have impaired mobility.

Even states with more out-migration than in-migration, such as California and New York, have grown in population. This is due to new birth and international migration. But enough people did exit Rhode Island and Michigan that those states lost population over the period.

Still Seeking South

North Carolina grew by 181,000 people overall, an increase of about 2 percent. Of those, more than half (98,000) moved in from another state; the rest of the increase stems from foreign immigrants and births. Still, the domestic migration numbers were off the 2006-2007 counts, by about 18,000 people. South Carolina grew overall by 1.7 percent year-over-year, and the bulk of those (75 percent, or 50,000 people) came from other states. But those numbers slipped, too, by almost 4,400 people.

Virginia and West Virginia netted only about 70,000 and 4,600 people, respectively. International migrants, almost 19,600, made up most of Virginia's increase; the rest was from births and domestic migrants. For West Virginia, 3,800, stemmed from state-to-state migrants. Virginia welcomed 2,670 people from other states. Maryland and Washington, D.C., got 14,700 and nearly 4,000 people, respectively, but most were international rather than domestic migrants.

Perhaps the biggest surprise in the numbers was Florida, the granddaddy of all Sunbelt destinations. Florida saw the first net out-migration in its history, attributed to the economic effects of its high mortgage foreclosure rate and

declining job opportunities. With 385,308 properties filing foreclosure papers in 2008, Florida had the second-highest rate in the nation. It's mostly the housing market slowdown, Frey says of Florida. People are moving to other parts of the country.

The Carolinas are accustomed to recessionary dips. They occurred in the early 1980s, 1990s, and the first part of the current decade. In 1980, for instance, North Carolina's net migrants declined from 31,148 people to 26,081 people in 1981, and fell further to 22,003 in 1982 before growing to 53,714 in 1983, coinciding with the end of the recession. (However, until 1990, the U.S. Census did not separate domestic migrants from international migrants.) North Carolina's net domestic migration fell from 46,295 in 2000-2001 to 43,785 the following year, a decline of about 1 percent.

Ditto for South Carolina, whose 24,500 in migrants in 1980 plummeted to 1,700 in 1981, and 631 in 1982, before climbing to 14,000 in 1983.

Carolina Life

Patrick Mason, co-founder of the Center for Carolina Living in Columbia, S.C., has published a biannual guide, *Carolina Living*, for 23 years. With a print circulation of 170,000, he estimates it reaches about 425,000 people, distributed by the North and South Carolina tourism departments, welcome centers, and convention and visitors bureaus. Mason says the guide is also sold in newsstands and bookstores in markets "known to be origin zips for movers to the Carolinas." The magazine contains a 26-question survey, and "when you run the data all together over time, you get a nice snapshot of trends," he says. The idea is not only to collect demographic information but also what Mason calls "psycho-graphic" information such as whether the respondents hike or golf.

Newcomers are almost always from the Northeast and Midwest, he says, and they often have been tourists first. According to the Internal Revenue Service Statistics of Income Division, South Carolina between 1990 and 1999 netted more than 20,000 in-migrants from New Jersey; almost 44,000 from New York; 12,600 from Ohio; and 17,400 from Pennsylvania. Between 2000 and 2007, the state had virtually the same numbers from New Jersey, but about 32,000 from New York, nearly 15,000 from Ohio, and 13,294 from Pennsylvania.

In the 1990s, South Carolina netted about 9,700 from Florida, and 9,500 from that state between 2000 and 2007, possibly quantifying the "halfback" phenomenon. That's when people migrate to Florida and then move halfway back up the coast. Of Mason's survey respondents, however, only

Estimates of the Components of Resident Population Change

July 1, 2007 to July 1, 2008 (Net Migration)

	Total Population Change	Total	International	Domestic
SC	74,886	54,849	5,113	49,736
NC	180,820	120,576	22,502	98,074
VA	70,314	22,243	19,565	2,648
WV	4,632	4,238	450	3,788
MD	14,698	-17,069	15,092	-32,161
DC	3,965	1,210	2,832	-1,622

SOURCE: U.S. Census Bureau

about 37 percent are older than 50, and few are younger than 30. That leaves people in the phase of life he calls “pre-retirement,” those searching for a place to retire.

But at the end of 2008, Mason’s survey response rate was about 20 percent off. “That’s the first indication we’re seeing that people are saying, ‘I don’t have time — we’ve got other priorities.’”

Primary and Return Migrants

James Johnson knows the literature of migration as a professor at the Kenan-Flagler Business School at the University of North Carolina at Chapel Hill and as a return migrant.

Johnson grew up in Falkland, N.C. (population 114) and he’s not the only African American from that community to leave for opportunity elsewhere, make his mark on the world, and return. Falkland has produced a brigadier general, a top official in the Government Accountability Office, and at least one dentist and doctor, among other successes. Like many blacks between 1900 and the 1980s, Johnson left the South. He graduated from North Carolina Central University in Durham, and migrated north where he earned graduate degrees at the University of Wisconsin (master’s) and Michigan State University (doctorate).

“When I left North Carolina near the tail end of this massive out-migration in 1975, I bought a one-way ticket, vowing never to return to the South,” he wrote recently in an op-ed piece for *The Washington Post*.

He landed in 1980 at the University of California at Los Angeles, where he lived until 1992, when UNC successfully recruited him back home. And Johnson reports other relatives and Falkland natives, including his brother, who have also returned to North Carolina.

“The structure of opportunity changed dramatically in the South, with good jobs available for talented people,” he says. In fact, there’s an “unofficial” recruiting strategy that state governments and private firms employ to lure former residents back to their home states, he says. “This notion that you have talented people who have gone away and done

Southern House-pitality

Southern states have long exerted a pull on people living in other regions, a trend that gathered steam as the South’s economy diversified and became less reliant on agriculture during the years following World War II. Since 1950, the South’s share of the population has grown from 24 percent to about 30 percent, and many of those states have boomed.

It’s the housing, among other factors. Harvard University economist Edward Glaeser has pointed out that the number of people in an area is “intimately tied (almost perfectly) to the number of homes. For instance, if states (like California) restrict housing supply through land-use regulations, then growth will decline, and that growth will move elsewhere.” California has had multiyear periods in which more people moved out of the state than into the state, both in the 1990s and the current decade.

“We found little evidence to support the view that the growth of the Sunbelt had much to do with sun-related amenities,” he writes in a paper on the subject. “However, our results do not mean that amenity improvements in the South such as air-conditioning or clean water were irrelevant.”

When people leave other states, it boosts the population growth elsewhere, including the South. (In fact, about 11,000 people moved to South Carolina from California between 1990 and 1999, and 9,000 between 2000 and 2007.)

Glaeser wrote the paper, “The Rise of the Sunbelt,” with co-author Kristina Tobio, published in the *Southern*

Economic Journal in 2008. Defining the South as the 11 former Confederate states, Glaeser and Tobio examined increased productivity, rising demand for sun-related amenities like warm winters, and flexible housing supply. The South’s productivity grew faster than the North through much of the postwar period, Glaeser says. That not only reflects “catch-up” with the already-industrialized North — the idea that poorer economies grow at faster rates than richer ones for a time — but the pro-growth southern business climate. That includes the right-to-work philosophy that dominates the South.

The paper found that population growth in the Sunbelt was driven primarily by productivity increases between 1950 and 1980. After 1980, though, the fast-growing and flexible housing supply has contributed mightily to Sunbelt growth, which reflects the influence of a pro-growth regulatory environment. Glaeser and Tobio conclude that “faster housing supply growth in the South has been at the very least almost an equally important factor as economic productivity in driving the rise of Sunbelt population.”

The authors also found little evidence that people are willing to pay for southern amenities such as warm weather. Incomes are going up more quickly than prices, which leads one to reject the view that somehow people are valuing sunshine more, he says.

—BETTY JOYCE NASH

well — can you entice them back? They have what is called location-specific capital,” he says. “If you tie economic opportunity with capital, then home places become a more attractive place to move.”

The issue of return migration has been studied extensively by demographers. In the years following the Great Depression, whites and blacks exited the South to find work. Blacks also wanted relief from Jim Crow laws and the deference customs in the South.

Whites show the highest rates of return migration (as well as constituting the numerical majority of such migrants) to the South over the past several decades, according to William Falk and Larry Hunt of the University of Maryland, and Matthew Hunt of Northeastern University. The authors published “Who is Headed South? U.S. Migration Trends in Black and White, 1970-2000” in the journal *Social Forces* in 2008. For blacks, they point out, the South may be more attractive than ever. More blacks hold elected political office in the South than elsewhere in the United States and selected areas — especially metropolitan Washington, D.C., and Atlanta — have experienced pronounced concentrations of black wealth.

Results of the paper show that the proportion of blacks, both primary and return migrants to the South, increased from 1970 to 2000. “The percentage of blacks who are recent primary (first-time) migrants increased threefold from 1970 (0.4 percent) to 2000 (1.2 percent), while the percentage of those who are return migrants increased by slightly more than a third (from 0.8 percent in 1970 to 1.1 percent in 2000).”

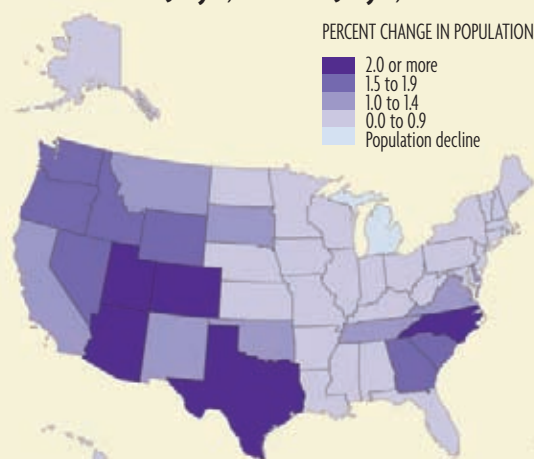
The authors also found that southern migration, while stable for whites, is increasing for blacks: The percentage of black non-southern residents who migrated south went from 2.2 percent to 6.5 percent during the decades between 1970 and 2000. The paper also showed a decline among whites and blacks leaving the South. For black people, the decline went from 4.3 percent to 2.0 percent compared with 5.2 percent to 4.1 percent among whites. “In short, more blacks are both ‘going home’ and ‘staying home,’ relative to whites,” according to the authors.

Because fewer blacks have left the South in recent years, there will be fewer migrants returning, so that stream seems to be drying up. Family connections, though, still reign when it comes to shaping migration choices.

Family Ties

While the South will no doubt continue to swell as the population ages and some seek the amenities of abundant and affordable housing, fewer people are moving. And that’s a continuing trend, according to the Pew Research Center’s

Percent Change in Population for States and Puerto Rico: July 1, 2007 to July 1, 2008



SOURCE: U.S. Census Bureau, Population Division, 2008

2008 American Mobility Survey. The survey of 2,260 adults was conducted in October 2008.

The survey found that almost 12 percent of Americans moved between 2007 and 2008, the lowest share since the government began tracking the trend in the late 1940s. The rate was at about 20 percent from 1946 through the mid-1960s before it started to fall.

Despite the bad weather rap, Midwesterners are the most rooted — 46 percent of adults say they’ve spent their whole lives in one community, compared to the West, where 30 percent have stayed in their hometown. In the South, that number is 36 percent and in the East, it’s 38 percent. Education and family ties make the difference. Seventy-seven percent of college grads have moved at least once and have lived in multiple states, compared to 56 percent with a high school or lesser education. People who’ve never left their hometowns have more family members — eight — within an hour’s drive than do others who have moved — three. Reasons to move include a better job; to stay, raising children and family proximity.

The survey divides states into “sticky” and “magnet” states,” with the Carolinas, of course, among the attractive magnet states, along with every state in the Fifth District except West Virginia. The share of residents in the District of Columbia who were born elsewhere and moved into D.C. is 63 percent; Maryland, 52 percent; Virginia, 49 percent; South Carolina, 41 percent; and North Carolina, 40 percent.

Among those who cite retirement as a reason for moving, half say the cost of living was a primary factor in choosing a locale. Perhaps that’s further evidence that housing supply and price drives the migration to the South that apparently, even during recession, remains strong. **RF**

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The Banking Landscape

Most of the 363 banks in the Fifth District hold fewer than \$5 billion in assets. In fact, most are community banks with under \$1 billion in assets. Banks of more than \$10 billion in assets and located primarily in specific regions are considered regional banks, while bigger banks (that do business over many regions in the United States) are considered “large complex banking organizations” (LCBOs).

Regional banks in the District include organizations such as Carolina First of Greenville, S.C., and First Citizens Bank and Trust Company headquartered in Raleigh, N.C. Large complex banking organizations in the district include Bank of America, N.A., RBC Bank, and Capital One Bank (USA), N.A.

In addition to size and operations, banking organizations are defined by chartering authority. During the formation of a new bank or even afterward, bankers make decisions about how, where, when, and why the new bank is going to be operated.

One of the primary decisions is what kind of bank it will be. Bankers must choose whether to be chartered by a state authority or by a federal agency and whether to be a member of the Federal Reserve System. These decisions will set the regulatory stage and begin to forge the banker-regulator relationship.

Of the 363 banks in the District, there are 99 state member institutions directly regulated by the Federal Reserve Bank of Richmond and a state chartering authority. The remaining banks in the District are regulated either by the Federal Deposit Insurance Corporation and the state chartering authority or the Office of the Comptroller of the Currency.

In addition to regulating state member banks, the Federal Reserve System regulates bank-holding companies and other financial entities such as foreign banking organizations and U.S. branches and agencies of foreign banks.

—BETTY JOYCE NASH

Largest Banks

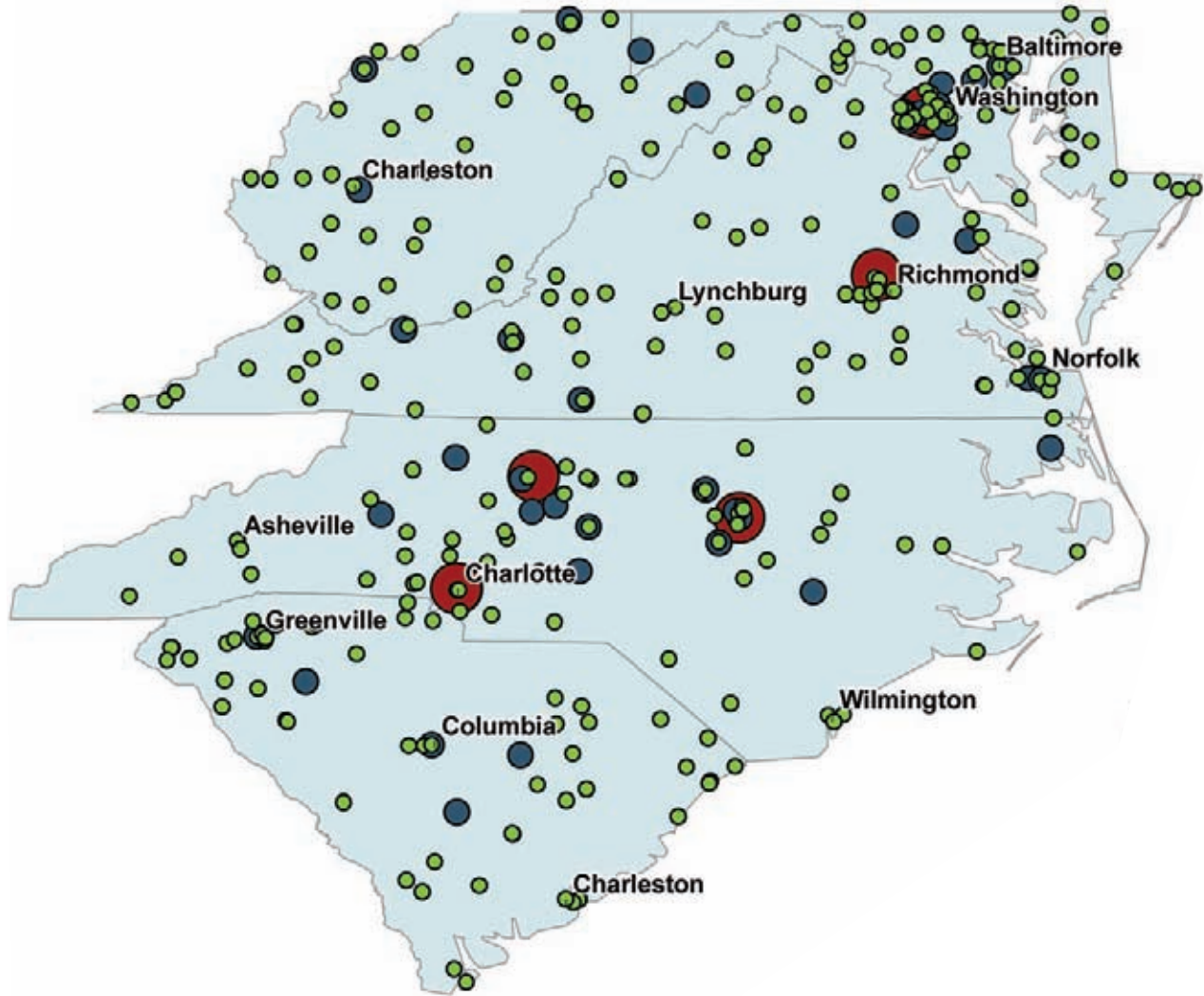
Bank of America	Charlotte, N.C.	\$1.5 trillion
Wachovia Bank	Charlotte, N.C.	\$635 billion
HSBC	McLean, Va.	\$182 billion
BB&T Corp.	Winston-Salem, N.C.	\$147 billion
Capital One NA	McLean, Va.	\$115 billion

Smallest Banks

Community Capital Bank of Virginia	Christiansburg, Va.	\$13.1 million
Nuestro Banco	Raleigh, N.C.	\$16.8 million
Great State Bank	Wilkesboro, N.C.	\$24.3 million
First State Bank	Danville, Va.	\$27.7 million
Bank of Westminster	Westminster, S.C.	\$29.6 million

NOTE: By asset size as of 12/31/2008. Bank assets include cash, loans, securities, property, and other real estate owned by the bank.

in the Fifth District



Assets

- \$13.2 million to \$1 billion
- \$1 billion to \$20 billion
- \$20 billion to \$1.5 trillion

NOTE: Does not include bank branches
SOURCE: Department of Banking Supervision & Regulation
Federal Reserve Bank of Richmond

George Selgin

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

To many, the idea that an economy can function without a central bank to issue currency or serve as a lender of last resort will seem bizarre. To economist George Selgin, the idea is one that needs to be taken more seriously.

Selgin, a monetary theorist and historian, has recently published a book titled *Good Money: Birmingham Button Makers, the Royal Mint, and the Beginnings of Modern Coinage, 1775-1821*. In it, he tells the story of how competition between private coin makers provided much-needed currency during a critical time in Great Britain's economic history.

Selgin's interest in monetary economics was piqued after he graduated from Drew University in 1979 with degrees in both economics and zoology. Upon reading a paper on "free banking" — a system in which private banks are able to compete with each other in the issuing of currency and operate without government restrictions — Selgin decided to pursue graduate studies at New York University under the paper's author, Lawrence H. White. After graduating from NYU in 1986, Selgin became a leading alternative voice in monetary economics.

Since 1989, Selgin has been a professor of economics at the Terry College of Business at the University of Georgia. Last summer he took leave from Georgia to serve as the BB&T Professor in Free Market Thought at West Virginia University.

Stephen Slivinski interviewed Selgin on the WVU campus on Dec. 11, 2008.



RF: Describe free banking. How does it differ from the sort of system we have in the United States today?

Selgin: I use the term to mean laissez-faire banking — banking without any special government regulations or restrictions. Like free trade, it's an ideal concept. It doesn't refer to any specific or actual banking system, although some, like Scotland's in the early 19th century, came close.

My own ideal version of free banking would have no special requirements for note issuance. Private banks would be able to issue their own notes on the same basis as they create demand deposits. They would also be free to open branches and invest in all kinds of securities. Finally, there wouldn't be any sort of implicit or explicit government guarantees, like deposit insurance.

RF: Is a commodity standard necessary in your hypothesized free banking environment? Or, to put it another way, is "fiat money" incompatible with free banking?

Selgin: I think a distinction needs to be made between the banking regime on the one hand and the monetary base regime on the other. The way I envision free banking, it does not rely on a particular base regime. It's true, as a matter of history, that if you had free banking from the get-go, you wouldn't have central banks and you would almost certainly have a commodity money standard, probably gold. But one

can conceive of free banking in a modern fiat money setting. What would make it free is that the central bank would not have a monopoly on issuing paper currency the way central banks do today almost everywhere.

A modern proposal for free banking that doesn't radically alter the monetary base regime is one that freezes the monetary base, lets banks issue any sort of liabilities — including currency — and gets rid of deposit insurance. The central bank would still maintain the monetary base but, in principle, it would just be a question of making sure it mopped up old central bank notes and otherwise maintained a fixed stock of reserve credit for banks to settle with. In that case, you'd have free banking with a fiat money standard.

The fiat money we currently have is purely the product of central banks. I think it's pretty clear that if we never had central banks, we wouldn't have fiat money. Instead, we'd still have commodity money. I don't think there were any evolutionary forces at work that would have weaned monetary systems off of established commodity standards, particularly gold and silver. What would have happened instead, and what was tending to happen while we still had those standards, was that the actual need for gold and silver as money would have fallen, thanks to financial innovations, to very trivial amounts.

In the Scottish free banking system, for example, actual gold coin reserve ratios had already fallen to as low as 1 percent to 2 percent of the banks' outstanding demand liabilities by the 1820s. Most of the liabilities were banknotes back then — deposits weren't so important. At any rate, the Scottish banks didn't need a lot of gold, and the system was always finding new ways to economize on it. But the ultimate standard was still gold, and I think it would have remained so in the absence of government interference.

RF: Do you consider fractional reserve banking inherently problematic? Does free banking require a commodity standard so private banks don't issue too much currency?

Selgin: The advantages of free banking are distinct from those of the gold standard or any commodity standard. That doesn't mean that I think there is no advantage to a gold standard. As a matter of history, I think it's a shame that the gold standard was dismantled. That dismantling really began in earnest during World War I, and the gold standard that was restored afterward was a jury-rigged and, ultimately, very unstable standard. But one can have a better banking system under free banking whether there is a gold standard or not. Fiat money would also work better with free banking than without it.

As for fractional reserve banking, I think it's a wonderful institution and that it's crazy to argue that we need to get rid

We should take private
production and issuance of
circulating money more seriously
than we do.

of it to have a stable monetary regime. Those self-styled Austrian economists, mostly followers of Murray Rothbard, who insist on its fraudulent nature or inherent instability are, frankly, making poor arguments. I don't think the evidence supports

their view, and that they overlook overwhelming proof of the benefits that fractional reserve banking has brought in the way of economic development by fostering investment.

The main thing to keep in mind is that a competitive bank of issue is one that can issue circulating currency but has no monopoly on doing so. So it isn't in a position to print up its own reserves or to print anything that other banks can be counted on to treat as reserves. Free banks compete, as it were, on an even playing field in issuing paper IOUs, which are basically what banknotes are. They have to redeem those IOUs on a regular basis: The competition among different issuers means that their notes will be treated the same way that checks are treated by banks today. They will be accumulated for a day or so and then sent through the clearing system for collection. It's this competition among issuers that assures that none of them has the power to lead the system into a general overexpansion.

That's quite unlike the situation you have when you have a monopoly bank of issue. Even in the presence of a gold standard, when the privileged banks' IOUs are themselves claims to gold, a monopoly bank of issue can expect other banks to treat its paper notes and its deposit credits, which are close substitutes, as reserve assets — that is, to treat them as if they were gold themselves. As a result of that tendency, which exists only because the recipient banks are deprived of the right to issue their own paper currency, the less privileged banks become dependent on the monopoly currency provider and, therefore treat its notes as reserve money. Now that monopoly bank has the power to generate more reserves for the whole system and it, in turn, is free of the discipline of the clearing mechanism. That's where central banks' power comes from. This is what allows central banks to promote a general overexpansion of credit and inflation.

What I just described is exactly the sort of thing that triggered many of the financial crises of the 19th century. The irony is that people now see these periodic crises, especially in England, as proving the need for a central bank and a lender of last resort. Walter Bagehot, on the other hand, recognized that the boom-and-bust cycles were a product of a monopoly in currency issuance.

Today, poor Bagehot must be spinning in his grave, because your average central bank apologist likes to cite him as having argued that every country should have its own central bank. That is a calumny. Bagehot in fact wrote very explicitly that he thought it would have been best had there never been a Bank of England, and if England instead had a competitive banking system like Scotland's. In that case

there would have been no need for any lender of last resort. In recommending that the Bank of England serve as such a lender, Bagehot wasn't recommending a solution to problems inherent in unregulated banking. He was just trying to get an inherently flawed Bank of England to behave itself.

RF: You've already mentioned the Scottish banking system of the early 19th century as the best historical example of a functional free banking system. How did the Scottish system emerge?

Selgin: The Scottish system was unique, and that's because of politics. After the 1707 Treaty of Union, English authorities did not want Scotland to end up with an institution with the same power and prestige as the Bank of England. They more or less insisted that Scotland allow open entry into the note-issuing business. So the Bank of Scotland, chartered in 1695, was followed by the Royal Bank of Scotland, and then by other note-issuing banks, until Scotland had a couple of dozen banks of issue — some big, some small — all competing. In this way the English quite unintentionally gave Scotland the world's most stable, most envied banking system, and one far superior to its own. For one thing, Scotland was relatively free of crises while England was buffeted by one crisis after another.

By the way, the same comparison can be made between the U.S. banking system and the Canadian banking system in the last half of the 19th century. Neither was a free banking system, but the Canadian system was freer in crucial respects, like allowing banks to issue notes without special collateral requirements and allowing nationwide branch banking. This greater freedom made the Canadian banking system the envy of U.S. commentators at the time.

RF: Supporters of central banking claim it is superior to free banking because the central bank can serve as a lender of last resort in a crisis or a contagion. Are there characteristics of a free banking environment that would obviate the need for a lender of last resort?

Selgin: The standard view is that banking systems are inherently fragile and that they'll be subject to frequent bank runs, which with fractional reserve banking will have very serious consequences. But there's no good evidence for this view.

Two things need to be said. First, truly irrational and random runs on banks, out of pure ill-informed panic, are the exception. In most cases the runs turn out to be based on relatively accurate information about which banks are insolvent and which ones aren't. In other words, so-called bank "contagions" tend to be very limited.

Secondly, the tendency for banking systems to suffer failures, especially big clusters of failures, depends on the regulatory environment. Had we had nationwide branch banking all along in the United States, that alone would have

allowed us to avoid many of the bank failures and problems we've experienced.

So, the question that has to be asked is not whether heavily regulated and structurally weak banking systems in the past could have benefitted from a lender of last resort. Perhaps they could have. It's whether the first-best solution is to get rid of the regulations that rendered these systems so artificially fragile in the first place. I don't think that *laissez-faire* or free banking systems, or the closest approximations we have been able to study, have demonstrated the sort of fragility that suggests the need for a lender of last resort at all. In my opinion, a lender of last resort is a second-best solution to problems caused by misguided regulation of banking systems.

Freedom to issue notes is important too. When banks can't issue their own notes, well, they need a lender of last resort to supply them with notes. If we told companies that manufacture shoes that henceforth they could only make shoes for left feet, lo and behold, there would be a need for an "emergency" source of shoes for right feet, which could be created by establishing a new government agency for the purpose. Eventually people would say, "Thank goodness for the Government Shoe Agency. How would anyone be able to walk otherwise?"

RF: What is the "big problem of small change?"

Selgin: The big problem of small change — which is the title of a very good book by Thomas Sargent and François Velde — refers to the problem of trying to keep smaller denomination coins circulating alongside larger denomination coins. Say you have a gold standard. If the mint strikes only full-bodied gold coins, the smaller denominations will end up being too tiny. You actually have historical examples of very tiny coins being issued. But people lost them, and they were otherwise very inconvenient. So, what else can you do? You can switch to silver or copper, but then your large denomination coins would be huge. In practice, no one metal can be convenient for the full range of denominations people need.

Instead, you can have two kinds of metal circulating as coins — that's called "bimetallism." But bimetallism has its own problem. So long as the mint sticks to a single unit of account, its coining rates will imply a fixed relative price for the two metals. But that price is bound eventually to differ from the world relative price. When it does, the metal that's relatively undervalued at the Mint will no longer be offered to it, and already-existing coins made from it will disappear from circulation unless they're badly worn.

The other solution, and the one that was adopted everywhere, is to use "fiduciary" or "token" coins. Here, the metal isn't the source of the coins' value, which instead rests on a contrived scarcity or their convertibility into nonfiduciary money. The trouble with respect to such coins is that they can be a tempting object for counterfeiters.

This brings us to the British case. By the 1780s, it was

estimated that more than 90 percent of the token copper coins in circulation in Great Britain were fake. And the real ones were in terrible condition. Merchants and factory owners could not get hold of enough decent coins for making change and paying workers. Of course, these problems were interrelated. The lack of decent official coins just made it easier for forgers to market counterfeit coins, while the extent of the counterfeiting discouraged the Royal Mint from producing more legitimate coins. At last, for several decades starting in 1775, the Mint decided not to produce any copper coins at all.

Great Britain also used silver coins as not-so-small small change, but because Great Britain's official bimetallic ration caused silver to be undervalued at the Royal Mint throughout the 18th century, no silver was being brought to the Mint to be coined. In other words, from 1775 onward, the Royal Mint produced hardly any small change of any kind.

Now, this was no small matter. Britons needed small silver and copper coins for all payments under a guinea. Banknotes didn't help, because the smallest until 1797 were for five pounds sterling. This was at a time when the average British worker was lucky to get 10 shillings, or half of one pound sterling, per week. So, retail exchange, wage payments — any transactions among the poor — there was no decent, official money for any of it. At the same time, the Industrial Revolution was gearing up. But that revolution depended crucially on the growth of retail exchange and the expansion of the factory system. It depended, in other words, on precisely the sort of exchange media that the government was no longer supplying. So the small-change shortage threatened to slow down the process of British industrialization.

Yet the British government, instead of trying to fix the problem, threw its hands up at it, leaving it to private merchants and industrialists to figure out a solution, which they did, ultimately, by minting and issuing their own coins.

RF: Tell me about your research into this historical episode.

Selgin: This private coinage episode, which is the subject of my book, was not a small thing. It was not a sideshow. In the course of 10 years, from 1787 to 1797, private coiners issued half again as many copper coins — in tons as well as in value terms — as the Royal Mint had issued throughout the previous half century. Later, the private coiners would issue silver coins too. So, for a big chunk of the early Industrial Revolution, the greatest part of the exchange medium used to sustain that revolution came from the private sector.

George Selgin

► Current Positions

BB&T Professor in Free Market Thought, West Virginia University (2008-2009); Professor of Economics, University of Georgia (1989-present)

► Education

B.A., Drew University (1979); Ph.D., New York University (1986)

► Selected Publications

Good Money: Birmingham Button Makers, the Royal Mint, and the Beginnings of Modern Coinage, 1775-1821 (2008); *The Theory of Free Banking* (1988); co-author, with Lawrence H. White, of "How Would the Invisible Hand Handle Money?" in the *Journal of Economic Literature* (1994)

Very few people know this story. What's more, it was only thanks to lessons learned from Great Britain's private coiners, both concerning how to make coins and how to administer the coining system, that the British government and other governments were finally able to get their official coinage arrangements in sufficient order to allow them to provide for the coinage needs of industrial economies. Yet governments still aren't very good at doing this. To this day there continue to be serious coin shortages around the world. Argentina has been in the grips of one for years. As long as we insist on letting government monopolize coinage, we can expect such shortages to occur.

That's where Sargent and Velde go wrong in their book. They insist on treating the small-change problem as being due either to government authorities not having the right theory about how small change should be supplied or to their not having the right equipment with which to implement the theory. They never really consider what one might call the "public choice" problems behind change shortages, including the perverse incentives involved in a bureaucratic and centralized mechanism for supplying coins. If you look carefully at the British story, the problem there was very clearly not a lack of sound theory or a lack of adequate equipment. Most of Great Britain's private or "commercial" coins were made using ordinary screw presses and were designed, issued, and administered by people who never lost a moment's thought to any theory, new or otherwise.

RF: How is your book relevant today to monetary policy?

Selgin: The real lesson I want to get across with the book is that we should take private production and issuance of circulating money more seriously than we do. Through their unthinking failure to question governments' coinage "prerogative," economists set a precedent that made it all too easy for them to excuse governments' subsequent monopolization of paper currency, which in turn paved the way to fiat money, unlimited government guarantees, and the prevailing international monetary chaos.

I wrote *Good Money* to challenge the oldest and most fundamental belief behind modern governments' control of money, by looking at a rare case where government didn't issue coins, but the private sector did. Contrary to what people assume, the episode suggests that the private sector alone is fit to coin money.

RF: Do you see reforms such as currency boards in

developing countries as a step toward your ideal of free banking?

Selgin: I think the view that currency boards represent a step toward free banking, perhaps even a big step, is partly due to the tendency to equate free banking with the lack of a central bank. I'm not saying that tendency is wrong, but it's a little bit misleading. There are ways of getting rid of central banks that may still leave commercial banks far from free, and currency boards are an example.

My perspective on currency boards is somewhat different. I agree that currency boards and dollarization can help us move toward free banking, but they do so by eliminating vested interests that tend to be among the most powerful opponents of granting greater freedom to banks. Once you dollarize, for example, whose concern is it domestically to prevent local banks from issuing their own currency? The currency profits — the seigniorage — are all going to another country. Allowing private institutions to supply currency would convert at least some of it to domestic consumers' surplus. There's no central bank to capture the seigniorage itself, and the treasury, which might otherwise look to a central bank to buy its debt, is now more likely to gain by encouraging than by standing in the way of currency privatization. So what dollarization and currency boards do is to get rid of at least some of the bureaucratic support for restrictions on commercial banks. In that sense, they represent a movement toward free banking.

RF: Do you see recent approaches to monetary policies and Fed actions as contributors to the current economic tumult?

Selgin: I agree entirely with those who blame the Fed for fueling the subprime housing boom by holding interest rates at such low levels for the early part of this decade. I think that was a very irresponsible policy. It was so even according to a conventional sort of Taylor rule, which, in my opinion, would itself have been too easy. Elsewhere I've defended the view that, in periods of growing productivity, central banks ought to allow some *deflation* — that is, monetary policy ought to be tighter than a standard Taylor rule would have it be. If you view the Fed's actual policy in light of this argument, then the policy was very expansionary. Taylor's own simulations suggest that if his rule had been followed, the housing boom would have been something like two-thirds as big. If the "productivity norm" I favor had been followed instead, the boom would have been much smaller still.

Still, it's a mistake to blame the Fed alone for the crisis. And, to some extent, one wants to pity the Fed because the truth is that central banks cannot get the money supply right. They are trying to centrally plan it and they do not have adequate information to go by. They could do better than they have done, I think, by adopting the right rules. But they are fundamentally flawed institutions.

In any event, the Fed provided fuel for the fire, but the fuel was being directed into the mortgage market, and

specifically into the subprime market, by an array of other government policies all aimed at increasing homeownership, especially among less creditworthy persons, and at helping the construction industry. The story is more complicated than that, of course, but these are the essential points.

RF: What do you think are the prospects for achieving something resembling free banking in the United States?

Selgin: Financial innovations tend to take us in the direction of free banking. Such innovations have already privatized the greater part of national money stocks, and will keep doing so in the absence of a wholesale nationalization of banks. It's only currency and coin that private firms have long been prevented from supplying.

So long as private currency remains illegal, and even if it doesn't, further financial innovation will tend to make us less and less dependent on any sort of paper currency or coins. Smart cards, debit cards, that sort of thing, have already made some inroads. And global pressures tend to favor the loosening of other kinds of bank regulations. There is, however, one kind of regulation that is growing instead of retreating and that market forces can't or won't resist, namely, government guarantees. Here things have been going the wrong way for a long time. The spread of deposit insurance and other explicit guarantees has been obvious enough. Everyone thinks you can't possibly have a stable banking system without deposit insurance, as if it weren't the case that only one country had deposit insurance nationally before 1967 and only two countries for a while after that. I think the spread of deposit insurance has been very unfortunate, and that the spread of *implicit* government guarantees has been still more unfortunate, because implicit guarantees really have no limits.

Thanks to government guarantees, moral hazard is *the* big problem in banking today. We've got branch banking in the United States, finally. We've got many good private substitutes for government currency. We've gotten rid of other restrictive regulations like Glass-Steagall. Banks have a lot of freedom now that they didn't have in the 1940s and that, so far as I'm concerned, is a good thing. But, tragically, back in the 1930s, when the government was busy saddling banks with regulations that would prove counterproductive, which it justified using false claims about banks' excessive risk-taking, it also saddled banks with deposit insurance, thereby encouraging them to take excessive risks.

I don't know how we're going to get away from deposit insurance and guarantees, but as long as we have them and expand them, we can look forward to bigger and bigger crises. So to me, the biggest banking reform we need — bigger than allowing banks to issue their own notes, bigger than allowing private mints to spring up — is to roll back federal guarantees to the banking industry. Unfortunately, doing that may prove to be an even bigger challenge politically than trying to privatize all the world's paper money and coin.

RF

West Virginia Glass Houses

BY BETTY JOYCE NASH

Natural gas, sand, and river transportation drew glass makers to West Virginia in the 19th century until those advantages dwindled

A woman marks a design on a glass for the cutter at Seneca Glass Co., opened in 1896 and closed in 1983 in Morgantown, W.Va. Seneca leaded crystal was favored by Eleanor Roosevelt and President Lyndon Johnson, among others.



The gatherer hoists a gob of hot glass at the end of an iron rod, a “punty” or “pontil” in trade lingo. A shop mate clips it off so that it drops into a water-soaked mold for another craftsman to hand spin until the mixture coats the inside. The bowl, now cooled slightly, is emptied onto a tray to await the oven that will reheat and evenly cool the ware to eliminate stress cracks.

It’s a frigid March day inside the shop at Blenko Glass, located on the Mud River near Huntington, W.Va. The company shut down in late January after a dispute when its former gas supplier emptied its bank account. The amount remains contested. But, for now, the shop is back in business. Blenko glass has retained its reputation for color (using more than 500 proprietary chemical concoctions) and distinctive shapes, and is one of just a few handmade glass factories still operating. Blenko sells a variety of ware, including architectural brick and stained glass to just about every stained-glass maker in the United States. There is Blenko glass in countless collections, churches, and sculptures, including pieces in the National Cathedral in Washington, D.C., and the glass brick at Fenway Park.

While Blenko shop artisans rely on the company’s century old formula for success, the world of sheet glass, tableware, and container glass production has largely vanished from West Virginia. Glass manufacturing offered an alternative to natural

resource extraction, but didn’t pan out the way some of the early 20th century boosters had hoped. Comparative advantages of cheap natural gas, sand, and river transportation eroded over the latter half of the 20th century in the face of falling demand and growing competition in a paper and plastic, free-trade world. Gas can be piped anywhere these days, but its growing cost is hurting the glass industry.

Growing Glass

The glass industry in the United States began in Jamestown, Va., at the time of the founding of the first English settlement, but did not thrive, even though craftsmen immigrated from Poland and Germany and helped develop the industry. The most successful glass houses grew up in New Jersey, New York, and the New England states. In those days, wood fueled the ovens that melted the raw materials.

By 1820, glass houses started to specialize and hire blowers for window glass and tableware. (To make sheet glass at that time, blowers formed cylinders that were then sliced and flattened. Irving Colburn mechanized the flat glass process in the United States around 1910.)

The industry expanded as factories grew, and tasks were divided, with the more routine jobs performed by the less skilled. A gatherer, blower, finisher, and, when press molds were invented in Pennsylvania in 1827, a presser, represented the chief glass jobs. Today, at Blenko, where the glass is still made by hand, this shop system of production remains intact, and some workers have logged more than 40 years in the shop. Often, they

follow the footsteps of fathers or uncles. The most skilled jobs are finishing and blowing.

“We’ve never hired glass workers as such. We’ve always trained our own people,” says the founder’s grandson, Bill Blenko Jr. “They know that no one will be promoted over them.”

By 1880, about 57 percent of U.S. glass house output came from Midwestern states such as Ohio as well as western Pennsylvania, especially around Pittsburgh. While there are reports of West Virginia glass works at Wellsburg and Wheeling as early as 1815 and 1831, respectively, it wasn’t until the final decade of the century that industry numbers grew substantially.

The Mountain State share of the national glass industry labor grew from 3 percent in 1890 to 12 percent in 1915 and 15.3 percent by the onset of the Great Depression, according to Kenneth Fones-Wolf, a West Virginia University historian who wrote *Glass Towns*. Beginning in 1890 “West Virginia glass plants and the capital invested in them would expand by a factor of five and its numbers of glass workers would triple.”

Between 1890 and 1920, mechanical improvements, especially the bottle-making machine, changed glass production so that “large-scale production became typical rather than exceptional, and the manufacture of glass products could no longer be considered ‘backward’ as compared with other industries,” wrote another economic historian, Warren Scoville, then of the Massachusetts Institute of Technology.

Gas for Glass

William John Blenko’s West Virginia shop was his second U.S. endeavor, and he arrived at the tail end of an industry restructuring driven by Friedrich Siemens’ changes in furnace technology in the 1860s and 1870s. The continuous tank furnace promoted efficiency — around-the-clock production using plentiful and cheap natural gas.

Blenko in 1893 had established one of the first natural-gas fired stained-glass factories in the United States, in Kokomo, Ind. Born and trained in London, he aimed to sell his product to domestic glass artists. However, they weren’t interested. These studios, headed by European artisans, insisted on European-made glass. Discouraged, Blenko headed back to London to export the same product he had crafted in Indiana, but later returned when he was in his 60s to start a glass house in West Virginia in 1921.

The West Virginia glass business benefited from the industry migration that followed the opening of the Midwestern gas fields around 1880. “Entrepreneurs had to weigh the advantages of being close to their materials against the savings which they could effect by locating near their own customers; and in the majority of cases they decided to construct their works near important sources of fuel,” wrote Scoville in 1944.

For example, Edward Drummond Libbey moved to Ohio from East Cambridge, Mass., partly because of labor problems but also because of the cost of transporting coal, which

by 1832 powered the New England glass works. He migrated in 1888 with 115 skilled workmen, according to Walter Lezius in another academic paper written in 1937. Michael Owens, a glass blower originally from Wheeling, W.Va., went to work for Libbey, an ironic twist because Owens had participated in the labor demonstrations at Libbey’s Massachusetts plant. In an illustration of the glass industry’s often-cozy relationship between management and labor, Libbey and Owens became partners. They developed a research and development business, Toledo Glass, to improve manufacturing processes, and they did. Owens invented the automatic bottle-blowing machine in 1903. By 1920, there were about 200 automatic Owens Libbey Suction Blow machines in the United States.

In 1917, the Libbey-Owens-Ford sheet glass plant opened in S. Charleston, W.Va., and cranked out sheet glass for 60 years. That plant and the Pittsburgh Plate Glass Co. in Clarksburg, W.Va., dominated that branch of the glass industry. Today, float glass, perfected by Sir Alastair Pilkington in 1959, has replaced sheet glass and is no longer made in the United States.

The bottle blowing machine also cut down on child labor because the bottle industry had previously depended on “mold boys” to open and close molds as well as boys to work as blow-pipe cleaners, among other jobs. By 1890, the number of children in glass factories had begun to dwindle — from 30 percent of the labor force to 20 percent — and by the end of the century, there were laws against child labor.

Technology, War, and Unions

Factory production ebbed and flowed with the push and pull of economic forces. For instance, domestic spending that had been deferred during World War I and increasing interest from abroad sparked heavy demand. But by the last half of 1920, consumer purchases slacked off and that caused inventories to build. Management enlisted the support of labor to help ease the pain. In the July 11, 1921, edition of *China, Glass, and Lamps*, a trade magazine, an article reported that the president of the American Flint Glass Workers Union urged members to “adjust the situation with the manufacturers in the best way possible ... American manufacturers have not yet reached that stage where they can keep on producing without letup when they have no orders for their goods.” But by 1922, production shifted as imports outpaced exports. In another example of the industry’s ups and downs, Prohibition slashed demand for barware and glass bottles until it was repealed in 1933.

This was reflected in employment, which fell to 55,000 in 1921 from 77,520, before it stabilized at about 67,000 between 1925 and 1929. In West Virginia, employment grew to 13,144 by 1929, but during the Depression fell to 8,759, with annual earnings declining by more than one-third from 1929 to 1932, according to Fones-Wolf. The industry rebounded by 1937, and a 1938 survey listed 62 glass plants in West Virginia, second only to Pennsylvania.

The state, however, had attracted the less valuable



Glass blowers at Seneca Glass Co. in Morgantown, W.Va., are shown working with a bubble of hot glass in the factory's massive blowing room, with 14 clay ovens.

branches of the industry. Even though 22 percent of the nation's glass plants were in West Virginia, it had only 15.3 percent of its workers and produced 13.8 percent total value, Fones-Wolf's research shows. Almost half, 45 percent, of the state's glass workers produced tableware, and that represented only 28 percent of the annual product value, while bottles and containers represented 37 percent of product value and employed 25 percent of the state's workers.

The decline had been foreshadowed even in the 1920s: That's when investment in manufacturing stopped growing. "The industry's share of manufacturing capital invested fell from 5.1 percent in 1909 to 2.6 percent by 1948, despite the enormous advances in mechanization," writes Fones-Wolf in *Glass Towns*.

Immigrants, Unions, and Tariffs

Early glass craftsmen like William John Blenko were immigrants, connected through family and professional contacts to worldwide glass production. Even in the 1880s and 1890s glass worker newspapers featured articles on the industry, not only from Europe and England but also from faraway Egypt and Russia, Fones-Wolf says in an interview. The hot glass industry furloughed every summer because of the heat, and immigrants returned home for family visits.

He cites an article from a glass industry newsletter about Belgian glass workers in West Virginia. Original plans had called for them to take guild positions in 1905 in Russia, but they immigrated to West Virginia instead because of timing — the Russian Revolution, which resulted in a series of industrial strikes. And Fairmont, W.Va., was home to several cooperative glass-making ventures, initiated by Belgian and French glass craftsmen.

As glass shops reshaped in size, location, and work force composition, attempts to unionize had culminated in the organization of the American Flint Glass Workers Union in 1878. Fones-Wolf notes that the "flints" went on strike in 1879, 1883, and 1888, for higher wages. Materials costs

decreased in all three parts of the industry: sheet, tableware, and bottles — while labor costs rose. In part, that's because glass required highly developed craft skills, such as blowing, until the first part of the 20th century.

The union and glass employers also were aided by tariffs first levied in 1789 to protect domestic industries. For example, between 1860 and 1890, heavy tariffs helped the industry gain market share, but supply began to exceed demand and led to plant closings and layoffs. In 1894, lower tariffs increased imports. By 1939, glass ranked 38th of 351 manufacturing groups surveyed by the Census Bureau, with 70,000 people employed in 229 companies nationwide.

Relations between labor and glass management were tight over the union's early years in part because the industry was composed mostly of descendants of the pre-industrial glass houses. They were from craft families and artisans themselves before becoming foremen and glass house managers. Labor and management sometimes worked together to support favorable legislation to benefit the industry.

Historians have debated the effects of tariffs on technological change in the glass-making industry. Scoville has suggested that high tariffs in part may have slowed innovation by cutting foreign competition in the 19th century. But historian Dennis Zembala, who has written about specialization in the industry, notes that press molds were invented in 1827, and innovations in furnace design came in the 1860s, among smaller developments. It was the bottle-making machine, invented in 1903, that revolutionized glass manufacturing and ultimately curtailed employment.

For example, Depression glass is simply machine glass made during the Depression. "It helped and hurt the industry," says Tom Felt, a collector who heads the West Virginia Museum of American Glass in Weston. "It allowed production, but then handmade glass became high end glass, and in the long run, it was too expensive to buy. The big costs are fuel and labor."

Union membership dwindled, hurt by industry mechanization as well as the chilling effect of crackdowns during coal miners' strikes in the teens and 1920s. The American Flint Glass Workers merged with the United Steel Workers in 2003, and their records are housed at the glass museum.

Bottles, Sheets, and Strands

Nationwide, the glass industry employs some 100,500 people and makes \$23 billion worth of product, according to the 2005 Annual Survey of Manufactures by the U.S. Census Bureau. That number declined from \$27.7 billion in 2001. The industry suffers from escalating energy costs and competition from low-cost labor markets.

Very little glass is manufactured in West Virginia anymore, and the West Virginia Museum of American Glass is working to chronicle and display the history of the once-thriving industry.

"The factory was the best-paying job," says Marcia Radcliff, a Weston woman who worked for 20 years at Louie Glass Co., one of at least three glass houses in the town, now

all closed. About eight firms remain in West Virginia, including firms like Blenko that manufacture glass by hand. Marble King in Paden City, W.Va., makes decorative, industrial, and play marbles. Masterpiece Crystal manufactures stemware in Jane Lew, W.Va. One of the most famous is the Fenton Art Glass Co. in Williamstown, W.Va., which sells via special order through its online catalog. And countless individual studio glass artists ply the

trade in shops throughout the state.

But for a generation, glass manufacturing influenced the culture and economy of West Virginia towns and created a flourishing middle class. The industry might have diversified the state's economy but did not, Fones-Wolf writes in *Glass Towns*: "It was, unfortunately, never enough to completely remake the region into an area that had a balanced and self-sustaining development." **RF**

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BALLPARKS • continued from page 27

amenity for people to have who are interested in that sort of thing."

Minor league sports don't put cities on the map or make outsiders think of them as "major league cities." They're intensely local and don't produce the public-good benefits that major league sports do, Johnson says. He's worked with economists on similar research about the National Hockey League's Pittsburgh Penguins and the National Football League's Jacksonville Jaguars. But some subsidy could be justified for major league venues, he says. "The willingness to pay is always much much lower than the cost of a stadium."

Appalachian Power Park in Charleston, W.Va., hasn't delivered nearby economic development to the city. But the ballpark, which houses the South Atlantic League's West Virginia Power, has still benefited the community, City Manager David Molgaard says. "The overriding benefits, at least to this point, have been intangible," he notes. "It's just

really become a gathering spot and the place to be in Charleston."

Events other than Power games have come to Charleston and are planned there because of the stadium. It's hosted the finals for the World's Strongest Man competition, boxing matches, community events like Oktoberfest celebrations, and more.

Appalachian Power Park also houses one of Minor League Baseball's colorful fans, the "toast man." He's Rod Blackstone, the assistant to the mayor. Blackstone is mentioned on multiple Web sites that offer reviews of ballparks. During Power games, Blackstone runs a toaster in the stands. When an opposing batter strikes out, he throws toast into the crowd to remind the player that he is, well, toast.

"He's part of the local flavor for sure," Molgaard says. "I tease him that we built the whole park around him and his toaster." **RF**

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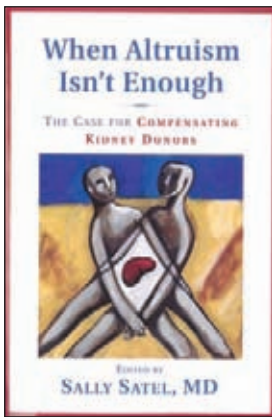
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Markets in Everything?



**WHEN ALTRUISM ISN'T ENOUGH:
THE CASE FOR COMPENSATING
KIDNEY DONORS**

EDITED BY SALLY SATEL
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REVIEWED BY AARON STEELMAN

In 2006, Sally Satel, a lecturer at the Yale University School of Medicine and a resident scholar at the American Enterprise Institute, a Washington, D.C.-based think tank, received a kidney donation. She was one of the lucky ones. “In the fall of 2008 in the United States,” she reports, “over 100,000 Americans were candidates for transplantable kidneys, livers, hearts, and lungs.”

The vast majority of transplant candidates — about 75 percent — need kidneys. But they face a mounting challenge. “Twenty-five years ago, the average wait for a deceased-donor kidney in the United States was about one year; currently, the average wait is approaching five years, and, in many parts of the country, it is nearing ten,” she writes. “Last year, over four thousand wait-listed individuals died.”

Considering the huge human cost of the failure to meet this demand, Satel and Richard Epstein, a law professor at the University of Chicago, organized a conference in July 2007 to discuss alternatives to the current U.S. transplant system. The event consisted of presentations by economists, philosophers, physicians, and others interested in exploring the possibility of a more efficient and humane way of allocating kidney transplants. The papers presented at that conference are collected in this volume.

To most economists, the idea of creating a “market” for organs is neither new nor inherently objectionable. But to many others, the idea seems ghastly, something out of a dystopian science fiction novel. In this volume, the economic arguments for compensating kidney donors are addressed — as well as the ethical concerns that may, in the end, prove to be the biggest obstacle to adopting such a system.

In 1984, the National Organ Transplant Act was passed. The Act banned offering “valuable consideration” to people in exchange for donating organs. In short, donors could not be compensated. This, according to David C. Cronin II, director of liver transplantation at the Medical College of Wisconsin, and Julio J. Elías, an economist at the State University of New York at Buffalo, “has failed to procure the requisite numbers of kidneys for transplant.” They outline two alternative approaches, one that they call the “free market system” and one they dub the “centralized system.”

Under the free market system, those in need of organs could potentially make private arrangements with donors, determining a price for the donation, making provisions for post-operative medical care, and handling other details that would be made contractually explicit. In a separate paper, Elías and economist Gary Becker of the University of Chicago have estimated that the compensation required to eliminate the shortage of organs would be roughly \$15,000. Such a system “would encourage some patients to secure transplant organs legally rather than turning to the black market, particularly since the wait in the legitimate system would be sharply reduced,” write Cronin and Elías. But they argue that such a system is too controversial and “will garner virtually no political support.”

The centralized system, on the other hand, would be more likely to gain such support. Under that system, donor compensation “would be fixed in advance by the government (federal or state), which would serve as the single payer and prospectively determine the type and duration of payments,” Cronin and Elías write. “The compensation could take any number of forms, including fixed payment or in-kind rewards, such as long-term health insurance, college tuition, or tax deductions, or a package that included some combination of these or other, equally valuable, alternatives.”

An obvious question raised by the centralized system proposal is: Wouldn’t such government compensation to donors increase the cost to the public? Possibly, but as explored elsewhere in the book, current government provision of dialysis treatment and other care needed by patients with severe kidney problems, through Medicare and Medicaid, is expensive too. On balance, then, a system that would use public funding to compensate people who otherwise might not donate organs likely would be less costly than the present system. And it would almost surely reduce the shortage of available organs, giving life to people who might die waiting for purely benevolent donors.

The economic and ethical arguments for adopting a more incentive-based system of organ transplantation — one that does not rely solely on the altruism of donors, as important and noble as these selfless acts certainly are — will seem strong, indeed compelling, to many readers. But they probably will not convince those people who open this book instinctively believing that paying people for organs is simply wrong. Ultimately, this debate involves more than simple cost-benefit analyses. It requires serious thought about difficult normative issues. But one has to wonder: Is it really desirable to cling to a system that fails to save the lives of thousands of people each year when an alternative approach is within our reach?

RF

Housing Markets, Financial Markets, and Recession: What About the Fifth District?

BY SONYA RAVINDRANATH WADDELL AND BETTY JOYCE NASH

The Fifth District's recession likely began in the spring of 2008, later than the national recession, which the National Bureau of Economic Research (NBER) dates from December 2007.

Like the national recession, the District downturn was ignited by a collapse in residential real estate markets. New construction, home prices, and consumer spending have been falling, while unemployment and mortgage delinquencies are rising. In addition, increased delinquencies of subprime mortgages and the subsequent decline in value of mortgage-backed assets have hurt financial institutions, further weakening the economy.

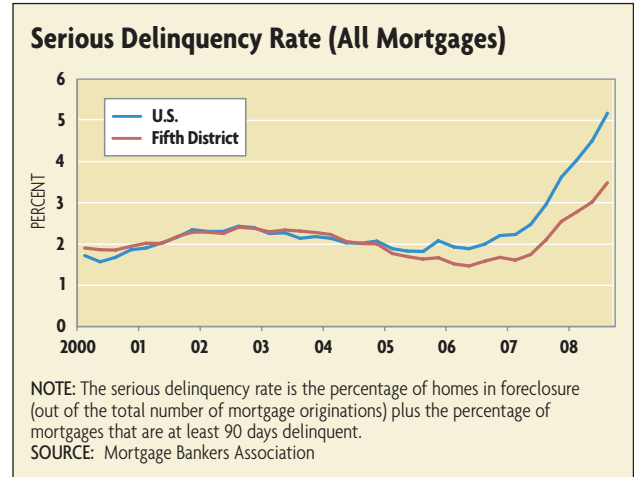
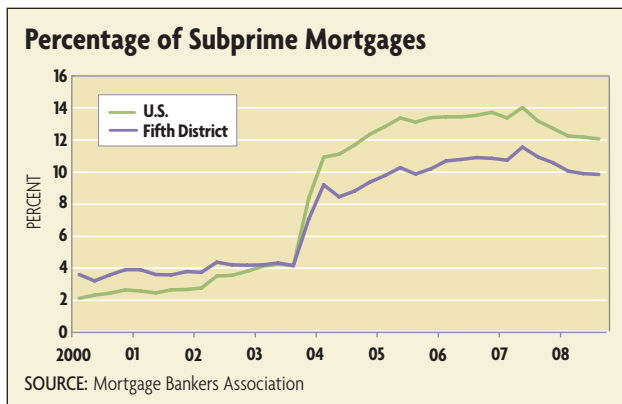
But through third quarter 2008, the District economy performed better than the U.S. economy, even when residential real estate is included in the mix.

District Prices

Housing markets in the District outperformed the nation in the first part of the decade, as did house price growth. From 2000 to second quarter 2007, house prices in the Fifth District grew 86.1 percent, an average annual rate of 9.1 percent, according to the Federal Housing Finance Agency House Price Index (HPI). Nationally, house prices grew 69 percent, an average annual rate of 7.5 percent, over the same period.

House prices rose dramatically in the Washington, D.C., metropolitan statistical area (MSA), which includes the District of Columbia and parts of Maryland, Virginia, and West Virginia. House prices in the MSA grew at an average annual rate of 12.9 percent from 2000 to 2007. Meanwhile, prices grew at an average annual rate of 12.3 percent in Maryland, 10.7 percent in Virginia, and 14.6 percent in D.C.

Although the D.C. metro area influenced total apprecia-



tion in Maryland and Virginia, prices in those states also increased considerably outside the D.C. region. The Lynchburg, Va., metro area saw the *slowest* annual average growth of all metro areas in Virginia and it grew at nearly 6 percent from 2000 to 2007. Meanwhile, in five of seven metro areas in North Carolina and three of four metro areas in South Carolina, house prices appreciated at an average annual rate of less than 5 percent between 2000 and 2007. In fact, price growth was less steep in North Carolina and South Carolina in general, where prices grew at an average annual rate of 5.2 percent and 5.6 percent, respectively.

West Virginia University economist George Hammond says most of West Virginia missed the housing boom except the areas that lie in or near the D.C. metro area. Prices grew sharply in the Winchester, Va.-W.Va., MSA early in the decade, and then declined by 17 percent from fourth quarter 2007 through fourth quarter 2008.

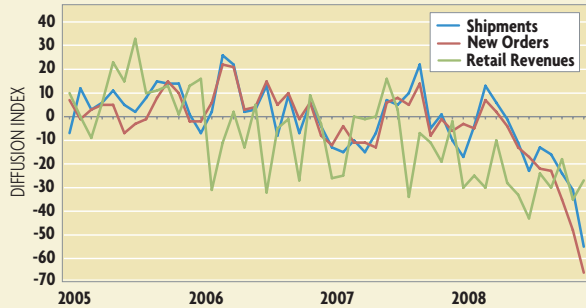
But statewide, prices in West Virginia grew by an average annual of 5.5 percent between 2000 and 2007. "West Virginia missed the worst excesses of the boom, so it's better positioned to miss the worst of the bust," he says. House prices declined by 0.5 percent over 2008.

Subprime Lending

The share of subprime lending in the Fifth District never reached that of the nation. But it accounted for nearly 11.6 percent of the District mortgage market in second quarter 2007 compared to almost 4 percent at the beginning of 2000.

The expansion of subprime lending was much stronger in

Fifth District Retail and Manufacturing Data



NOTE: The diffusion index equals the percentage of responding firms reporting increase minus the percentage reporting decrease.
SOURCE: Federal Reserve Bank of Richmond

D.C., Maryland, and Virginia than in the Carolinas. In Maryland and Virginia, for example, the number of subprime mortgages expanded more than fivefold from 2003 through second quarter 2007. Over the same time frame, the number of subprime loans in the Carolinas more than doubled. Even though house price growth, financial market innovations, and policy decisions enabled more lending in the District, the share of subprime lending did not grow as sharply as it did nationally.

As the overall U.S. housing market began to show signs of stress toward the end of 2006 and into 2007, reports indicated stronger conditions in the Fifth District than the nation. Nationally, subprime “serious” delinquency rates had begun to climb toward the end of 2006. Serious

QUICK FACT

Subprime loans are those extended to borrowers whose credit is impaired or who have limited or no documentation on income or assets, high loan-to-value ratios, or high payment-to-income ratios.

delinquency rates represent the percentage of homes in foreclosure plus the percentage of mortgages at least 90 days delinquent. In fourth quarter 2006, the subprime serious delinquency rate was nearly 8 percent, but by third quarter 2008, the rate had jumped to 19.6 percent.

In the Fifth District, it was mid-2007 before serious delinquency rates started rising. The subprime delinquency rate jumped 8 percent from second quarter 2007 to 15 percent by third quarter 2008.

As subprime delinquencies rose, the value of investment assets backed by mortgage loans fell, setting off a string of problems in the financial sector. With rising delinquencies and a stalled housing market, house prices peaked in the second quarter of 2007 and began the first national decline in history, falling 4.5 percent by third quarter 2008. In the Fifth District, prices over the same period fell almost 3 percent.

As prices fell and homeowners continued to lose equity, prime delinquencies also started to rise. Although delinquency and foreclosure rates have remained below national levels, the measures have risen notably in every jurisdiction of the Fifth District.

The Economic Consequences

As the boom in housing ended, residential construction activity declined. Permit levels and housing starts have fallen, workers in construction and manufacturing have been laid off, and consumer spending has fallen. As house prices have fallen, even those households not in danger of losing their homes have felt less wealthy and have reduced consumption.

Failed banks and mortgage companies also have left employees without work, and economic uncertainty has contributed to significant fluctuation in the stock market, which has eroded consumer confidence and further reduced spending. Furthermore, the deleveraging of financial firms and heightened concern over the quality of borrowers has reduced lending, making it difficult for businesses and individuals to secure loans. Manufacturers, retailers, and financial firms are all suffering, payrolls have fallen, and unemployment has risen.

The NBER estimates that the United States went into recession in December 2007. Using state data along with monthly manufacturing and service sector data from Richmond Fed surveys, we can estimate the timing and depth of the recession in the Fifth District.

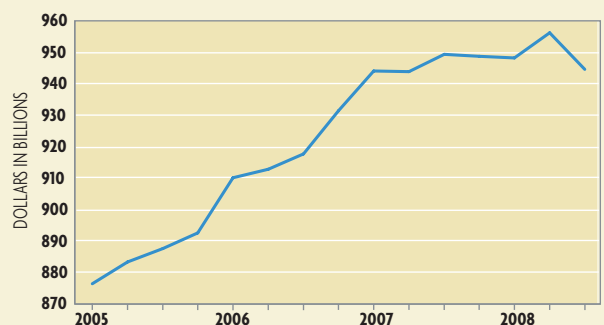
Employment in the Fifth District peaked in the spring of 2008. Payroll employment estimates indicate a peak in February 2008, with the household survey indicating an employment peak around the same time. It was also in the spring of 2008 when the number of unemployed in the District began to grow beyond fluctuations of recent years.

Personal income may have peaked in the second quarter of 2008, although this conclusion could change as more data become available. Peaks in the indexes for Fifth District manufacturing and retail sales measured by the Richmond Fed survey are also difficult to judge. Nonetheless, in March

QUICK FACT

Alternative-A (Alt-A) mortgage loans are those extended to borrowers with strong credit histories, but nontraditional characteristics, such as reduced documentation, a low downpayment, or a house that is not owner-occupied.

Fifth District Real Personal Income



SOURCE: Bureau of Labor Statistics, Seasonally Adjusted

2008 the indexes for both shipments and new orders in manufacturing began to fall to levels far below what the measures have seen even in the difficult environment of the past few years. In the retail sector, the index for revenues peaked in June 2007, but the index started dipping to extremely low levels in April 2008.

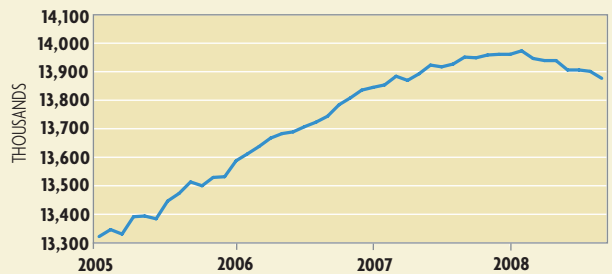
From these data, therefore, it appears that the Fifth District is in a recession that began in the spring of 2008 — a few months after the national recession began.

Looking Forward

Although in the early part of this episode, housing markets in the Fifth District fared better than the aggregate national market, they have slowed enough to create problems elsewhere in the economy. In addition, the depth of the regional recession is likely to be affected by the stress on the banking sector caused by the mortgage crisis.

A primary reason for the relatively more stable housing conditions in the Fifth District was the strength of the Carolinas. But house prices in North Carolina and South Carolina posted their first declines in the third quarter of

Fifth District Payroll Employment



SOURCE: Bureau of Labor Statistics, Seasonally Adjusted

2008. While reports on existing home sales and new residential construction indicate some potential firming in the northern part of the District and other parts of the country, conditions in the Carolinas have deteriorated further. The

sluggishness in residential real estate may persist in the Carolinas after conditions start to turn around in the nation and the D.C. area. This could impede the quick recovery of the Fifth District economy. **RF**

QUICK FACT

In securitization, the cut-offs between tranches for structured products are usually chosen to ensure a specific rating. The safest offer investors a relatively low interest rate, but are the first to be paid out of the cash flows from the assets. Those tranches are usually rated AAA. Tranches that will be paid only after other tranches are paid out typically have much lower ratings.

Subprime Primer

An expansion in lending to people who previously would not have had the opportunity to buy homes — so-called Alt-A and subprime mortgage lending — fueled the housing boom. According to Mortgage Bankers Association data, the number of prime mortgages serviced in the United States almost doubled from 2000 to 2007, while the number of subprime mortgages grew almost tenfold.

Fifth District mortgage growth was less skewed toward subprime. Over the seven-year period, prime mortgage lending more than doubled in the District while there were about five times as many subprime loans made.

Although future research will shed more light on this recent episode, there is some consensus that policy decisions, house price appreciation, and innovations in the financial system all contributed to the escalation of subprime lending.

First, accommodative monetary policy and government programs targeted at homeownership encouraged institutions to lend and people to buy homes. Second, steep house price appreciation allowed borrowers to take on more house than they ultimately could afford. Borrowers used escalating home values to refinance and extract equity. Finally, the traditional banking model of originating and maintaining a mortgage or loan was

replaced in recent years by an “originate and distribute” model.

Here is how that works: After making a loan, banks typically form portfolios of mortgages, loans, corporate bonds, or other assets (called “structured products”) and slice them into tranches, or groups, before selling them in the market. The tranches are then sold separately to, for example,

pension funds, hedge funds, or structured investment vehicles. This “securitization” was the main financing method of the major subprime mortgage originators. It spread risk, enabling lower interest rates.

Securitization also increased the available pool of money for loan originators because it allowed investors to indirectly hold assets that they were previously prevented from holding for regulatory reasons. For example, certain pension funds that could invest only in AAA-rated fixed-income securities could invest in a AAA-rated senior tranche of A-rated securities.

Toward the end of 2006, national subprime serious delinquency rates began to climb. Those are the percentage of homes in foreclosure plus the percentage of mortgages at least 90 days delinquent. In the last quarter of 2006, the subprime serious delinquency rate was 7.8 percent, but by third quarter 2008, the rate was 19.6 percent.

—SONYA RAVINDRANATH WADDELL

Outside the Urban Range: House Prices in the Rural Fifth District

House price appreciation has stalled in nonmetro areas of the District. Prices for land, with its variety of uses, are more difficult to gauge and appear to vary from state to state.

About 17 percent of people in the United States live in places outside the commuting range of urban or metro areas of more than 50,000 people. The classification is used to define "rural" for research and policymaking.

Rural areas didn't grow as much as metro areas over 2000 to 2005, according to the Economic Research Service of the United States Department of Agriculture. Nonmetro area populations increased only slightly, about 2.2 percent, compared to a 5.3 percent increase in urban areas over the first half of this decade.

In 2008, the Federal Housing Finance Agency released indexes for nonmetro house prices. Those measure the rates at which prices changed from quarter to quarter, year to year. The indexes show that in all Fifth District states, prices reflected metro prices: They began to rise in the early part of the decade.

Year-over-year house price appreciation in nonmetro areas started to slip by fourth quarter 2005. Growth peaked at 9.2 percent in North Carolina at the end of 2005, but slowed to 4.6 percent by fourth quarter 2007, and further to 1.7 percent by the end of 2008.

In South Carolina, the year-over-year change slipped to -0.8 percent by the end of 2008, after having reached a growth rate of 10 percent as late as mid-2006. In Virginia, house price growth peaked in 2005 at 17.7 percent over the previous year but by 2008 had fallen to -1.4 percent.

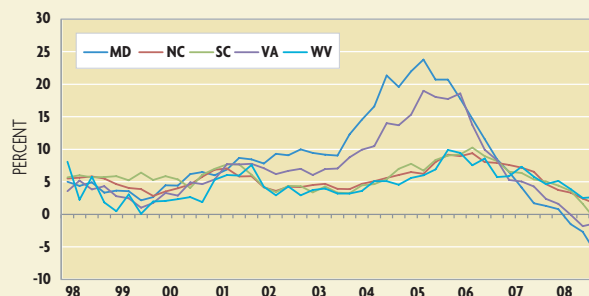
While those price indexes apply to home prices in nonmetro areas, land prices are trickier to evaluate because of the wide variety of ways land is used: agriculture, pasture, and residential development.

Land prices don't appear to be on the decline in North Carolina, according to Mike Huskey. He heads the farm loan programs for the United States Department of Agriculture in Raleigh, N.C. "Traditionally up until this year, land prices were on the increase, 10 percent to 12 percent, but even that would vary," he says. "I think people are still investing in land — they see it as a better investment than the stock market. There are probably fewer transactions now with the economy being the way it is, but people are still investing in land."

His agency lends to farms, and loans have increased. "I don't know what to attribute it to," he says. "But credit is

Regional Nonmetro House Prices

(Year-over-Year Percent Change)



SOURCE: Federal Housing Finance Agency

tighter in the private sector. That's part of it."

Lori Lynch, an agricultural economist at the University of Maryland, has studied land prices for her research into the viability of Maryland's land preservation program. "We're half agriculture, half forest. The study we did looked at whether or not we could save a million acres."

Rural land prices are influenced by the potential for residential housing development. In Maryland, she says, land prices throughout the state, even in the most remote corners, seemed to have appreciated because of that possibility. "Garrett and Allegany [counties] would be least urban influenced, but they also were getting second home purchases," she says.

"Between 2002 and 2005, agricultural land prices went up more than 100 percent, while the agricultural value of the land went up 12 percent to 14 percent," she says. That's what the land would be worth for agricultural uses, not development.

"They seem to think that any time they want, they could just find a developer and sell their land, move to Florida, and live happily ever after. Whether that's factual is really, really hard. There's a lot of land in Maryland," she says.

But now the market has dried up. "The bottom line — the market has just stopped. It started slowing down in 2005. There's not a lot of action because we don't have that many transactions."

As for foreclosures, she hasn't heard of even one in Maryland. "That doesn't seem to have hit the farm community the same way," she says. "I haven't even heard people talking that much about credit problems." Farmers seem more concerned about input prices.

—BETTY JOYCE NASH

QUICK FACT

Nonmetro House Price Appreciation

	2007	2008
MD	1.3	-5.8
NC	4.6	1.7
SC	5.0	-0.8
VA	2.4	-1.4
WV	4.6	2.7

SOURCE: Federal Housing Finance Agency

State Data, Q3:08

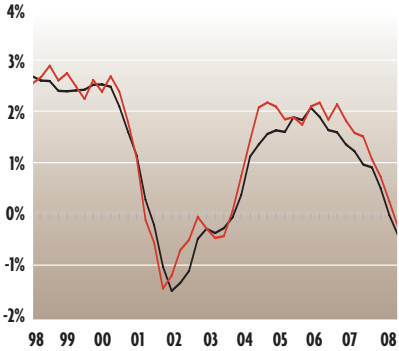
	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000's)	709.7	2,597.9	4,132.0	1,924.6	3,767.3	763.2
Q/Q Percent Change	0.8	-0.4	-0.3	-0.9	0.0	0.4
Y/Y Percent Change	2.4	-0.5	-0.6	-1.2	0.1	0.6
Manufacturing Employment (000's)	1.6	128.0	512.3	241.9	264.2	56.1
Q/Q Percent Change	-4.0	-0.9	-1.6	-1.4	-1.1	-1.3
Y/Y Percent Change	-4.0	-2.9	-4.6	-3.0	-4.5	-4.8
Professional/Business Services Employment (000's)	153.2	399.0	504.2	219.3	659.1	60.6
Q/Q Percent Change	0.0	0.6	-0.6	-2.6	0.3	-0.5
Y/Y Percent Change	0.7	0.3	0.3	-3.5	1.7	-0.5
Government Employment (000's)	236.5	488.9	708.7	343.2	697.3	147.2
Q/Q Percent Change	1.0	0.5	0.7	-1.2	0.9	0.7
Y/Y Percent Change	2.3	2.0	2.7	2.2	1.9	1.4
Civilian Labor Force (000's)	333.9	2,999.2	4,552.2	2,160.3	4,129.4	804.6
Q/Q Percent Change	0.5	0.1	0.6	0.9	0.4	-0.3
Y/Y Percent Change	2.4	0.3	1.0	1.7	1.3	-1.2
Unemployment Rate (%)	7.2	4.5	6.6	7.2	4.1	4.2
Q2:08	6.6	4.1	5.9	6.3	3.8	4.3
Q3:07	5.5	3.5	4.8	5.6	3.0	4.5
Real Personal Income (\$Mil)	31,431.8	221,375.0	259,648.4	116,637.5	272,180.8	45,845.7
Q/Q Percent Change	-0.6	-0.8	-1.3	-1.6	-0.9	-0.6
Y/Y Percent Change	-0.1	-0.4	0.0	-0.2	-0.8	1.2
Building Permits	152	3,819	14,572	6,706	6,308	873
Q/Q Percent Change	-19.6	-2.3	-6.3	-16.9	-14.1	4.1
Y/Y Percent Change	-71.2	-18.4	-26.7	-20.5	-24.5	-10.8
House Price Index (1980=100)	622.2	500.7	345.8	325.6	452.8	229.5
Q/Q Percent Change	-1.5	-2.9	-0.5	-0.6	-1.7	-2.1
Y/Y Percent Change	-5.7	-6.3	2.2	2.3	-3.8	0.2
Sales of Existing Housing Units (000's)	7.2	65.6	153.6	80.4	126.4	25.2
Q/Q Percent Change	0.0	1.9	-9.0	-6.9	11.7	-3.1
Y/Y Percent Change	-21.7	-18.0	-24.3	-22.4	12.9	-7.4

NOTES:

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

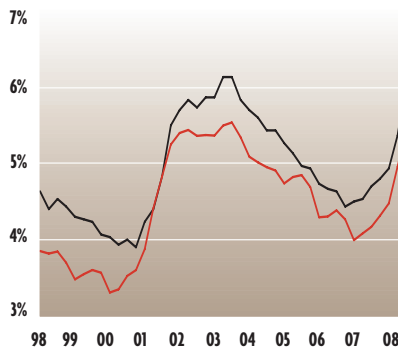
Nonfarm Employment

Change From Prior Year
First Quarter 1998 - Third Quarter 2008



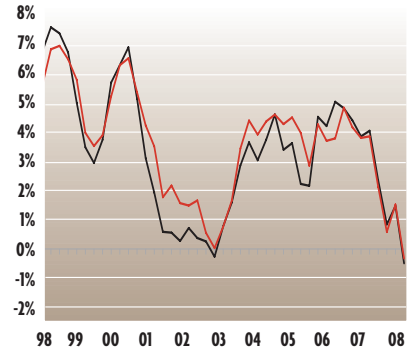
Unemployment Rate

First Quarter 1998 - Third Quarter 2008



Real Personal Income

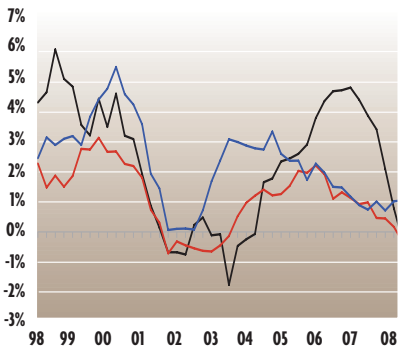
Change From Prior Year
First Quarter 1998 - Third Quarter 2008



— Fifth District — United States

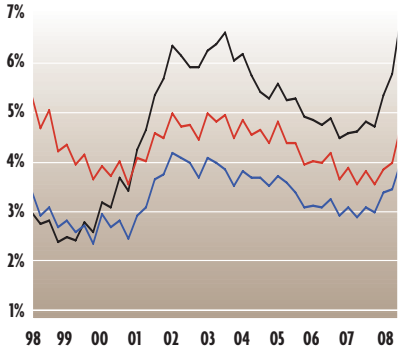
Nonfarm Employment Metropolitan Areas

Change From Prior Year
First Quarter 1998 - Third Quarter 2008



Unemployment Rate Metropolitan Areas

Change From Prior Year
First Quarter 1998 - Third Quarter 2008

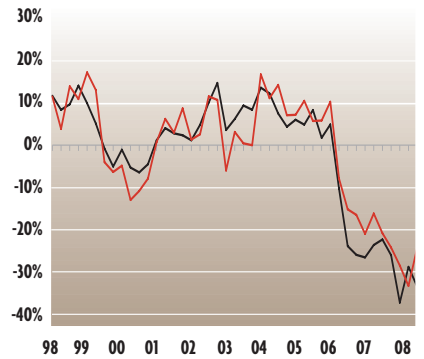


— Charlotte — Baltimore — Washington

— Charlotte — Baltimore — Washington

Building Permits

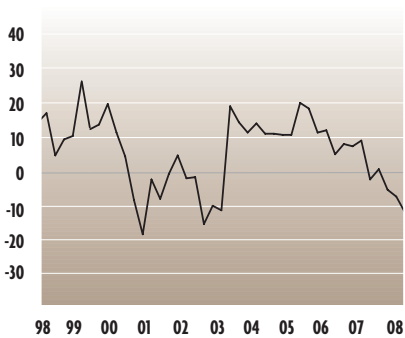
Change From Prior Year
First Quarter 1998 - Third Quarter 2008



— Fifth District — United States

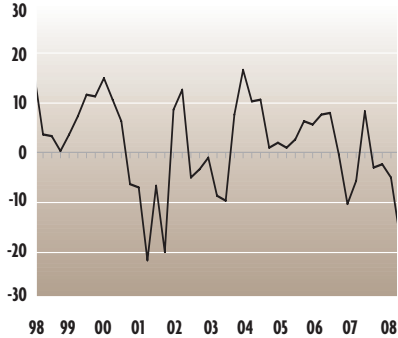
FRB—Richmond Services Revenues Index

First Quarter 1998 - Third Quarter 2008



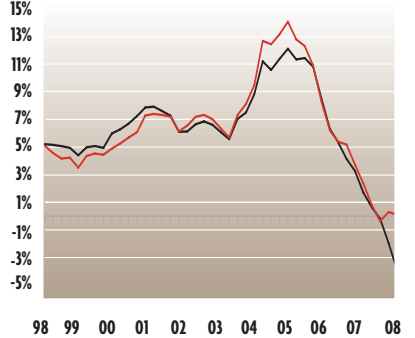
FRB—Richmond Manufacturing Composite Index

First Quarter 1998 - Third Quarter 2008



House Prices

Change From Prior Year
First Quarter 1998 - Third Quarter 2008



— Fifth District — United States

NOTES:

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

SOURCES:

Real Personal Income: Bureau of Economic Analysis/Haver Analytics.
Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
Building permits: U.S. Census Bureau, <http://www.census.gov>.
House prices: Federal Housing Finance Agency, <http://www.ofheo.gov>.

Metropolitan Area Data, Q3:08

	Washington, DC	Baltimore, MD	Hagerstown-Martinsburg, MD-WV
Nonfarm Employment (000's)	2,440.7	1,316.7	101.1
Q/Q Percent Change	-0.1	-0.7	-0.9
Y/Y Percent Change	1.1	-0.3	-1.6
Unemployment Rate (%)	4.0	4.8	5.1
Q2:08	3.5	4.0	5.3
Q3:07	3.1	3.8	4.3
Building Permits	3,458	1,621	281
Q/Q Percent Change	-6.7	29.5	-11.9
Y/Y Percent Change	-23.7	-6.9	-40.8

	Asheville, NC	Charleston, SC	Durham, NC
Nonfarm Employment (000's)	175.4	854.6	292.2
Q/Q Percent Change	-1.3	-1.4	-0.1
Y/Y Percent Change	-1.1	-0.3	1.5
Unemployment Rate (%)	5.4	7.0	5.4
Q1:08	4.6	5.8	4.7
Q2:07	3.5	4.8	3.9
Building Permits	483	2,642	542
Q/Q Percent Change	-11.2	-32.2	-15.4
Y/Y Percent Change	-39.9	-45.3	-27.2

	Greensboro-High Point, NC	Raleigh, NC	Wilmington, NC
Nonfarm Employment (000)	365.0	520.7	146.7
Q/Q Percent Change	-1.2	-0.3	-1.5
Y/Y Percent Change	-1.4	0.6	-1.3
Unemployment Rate (%)	7.1	5.4	6.1
Q2:08	5.9	4.5	5.1
Q3:07	4.9	3.6	3.9
Building Permits	679	4,007	967
Q/Q Percent Change	-26.4	26.4	-12.8
Y/Y Percent Change	-40.1	-11.8	-24.9

For more information, contact Sonya Ravindranath Waddell at (804) 697-2694 or e-mail sonya.waddell@rich.frb.org

Metropolitan Area Data, Q3:08

	Winston-Salem, NC	Charleston, SC	Columbia, SC
Nonfarm Employment (000's)	216.2	301.5	365.2
Q/Q Percent Change	-1.5	-1.2	-1.0
Y/Y Percent Change	-0.3	0.6	-0.3
Unemployment Rate (%)	6.5	6.1	6.5
Q2:08	5.4	4.8	5.3
Q3:07	4.5	4.8	5.4
Building Permits	353	1,090	1,375
Q/Q Percent Change	-16.0	-16.7	9.8
Y/Y Percent Change	-50.9	-31.9	0.2
	Greenville, SC	Richmond, VA	Roanoke, VA
Nonfarm Employment (000's)	318.6	628.5	161.8
Q/Q Percent Change	-1.4	-1.0	-0.9
Y/Y Percent Change	0.9	-0.8	-0.8
Unemployment Rate (%)	6.3	4.7	4.3
Q1:08	5.1	4.0	3.7
Q2:07	5.4	3.2	3.1
Building Permits	596	1,129	141
Q/Q Percent Change	-46.3	-4.7	-25.4
Y/Y Percent Change	-42.7	-27.6	-36.2
	Virginia Beach-Norfolk, VA	Charleston, WV	Huntington, WV
Nonfarm Employment (000)	775.6	153.1	118.8
Q/Q Percent Change	0.2	0.7	-0.4
Y/Y Percent Change	-1.1	1.1	-0.8
Unemployment Rate (%)	4.6	3.3	5.1
Q2:08	3.9	4.5	5.3
Q3:07	3.3	4.0	4.8
Building Permits	1,301	4,007	8
Q/Q Percent Change	-24.9	169.6	-33.3
Y/Y Percent Change	-4.1	101.3	-75.8

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No Time for Protectionist Impulses

BY JOHN A. WEINBERG

Imagine you plan to build a deck on your house. You might purchase all the goods from a local store, but originally the lumber might have come from Canada, the nails from China, and the varnish from England. Now, imagine what that process might entail if the government decided that you couldn't purchase those imported goods. Instead, they had to be produced domestically. Your deck would almost certainly be more expensive — and it may be of lower quality. That's because there would be less competition among firms to provide the necessary supplies.

That's roughly analogous to the situation created by the recent economic stimulus package passed by Congress and signed into law by the president in February. It includes a rule — commonly called a “Buy American” provision — that binds all contractors working on infrastructure projects to use iron, steel, and other manufactured goods produced only in the United States.

Realizing this might cause some problems, Congress did insert language into the final version of the bill that would allow a waiver of these provisions in cases where 1) federal agency heads deem that it is “inconsistent with the public interest” 2) a particular product is not made in the United States or is not made in sufficient quantities domestically or 3) these rules would increase the overall cost of a project by more than 25 percent.

The last point suggests that policymakers are concerned that “buying American” could, in fact, wind up costing Americans considerable sums of money on public projects. But it's not clear why that particular figure was chosen. Why not 20 percent or 30 percent? In any of these cases, there still would be a significant subsidy to domestic producers — some of whom may be less efficient producers of these goods and may already be shielded from competition by existing tariffs and other trade barriers.

In fact, it's hard to see how any cost overrun is not “inconsistent with the public interest.” It is incumbent upon policymakers to make sure that taxpayer money is spent as efficiently as possible.

The “Buy American” provision is an example of what seems to be a creeping return to a form of economic nationalism. It might remind economists and historians of the early 1930s, when the United States turned its back on the world economy with ill-guided laws like the Smoot-Hawley Tariff Act. Dozens of other countries retaliated and world trade fell about two-thirds within five years, deepening the economic crisis.

Another example of this trend is a provision in the appropriations bill signed by the president in March. Within that bill was the discontinuation of a pilot program that allowed Mexican trucks to haul cargo over long distances on American roads, probably reducing transportation costs — and ultimately the costs of the products being imported. As a result, Mexico has already retaliated by imposing duties on \$2.4 billion worth of U.S. goods that they import, ranging from pencils to toilet paper.

There are some glimmers of light on the trade horizon in the wake of these questionable policies. President Obama, although he signed the bill that restricted trucking access, has publicly stated he wants to find a way to re-open these trade routes to Mexican trucks. And the final language of the

stimulus bill does require implementation of the “Buy American” rules to fall within the boundaries of international trade agreements, like the General Agreement on Tariffs and Trade and the North American Free Trade Agreement. If a certain stimulus-related transaction violates any of these, a waiver may be granted.

The intent, however, of these protectionist provisions is obvious. It indicates an interest among some policymakers to further restrict access that U.S. consumers and producers have to foreign goods. It would be hardly surprising if other countries retaliated the way Mexico did. Countries like China, Brazil, and Russia, for instance — countries that are either not included in government procurement accords or do not have free-standing trade pacts with the United States — may be shut out of the chance to supply materials for any stimulus-funded infrastructure projects. According to Census Bureau data, 39 percent of all U.S. nonagricultural imports hail from countries affected by the “Buy American” provision.

Policies like these beg the question of whether the government should be involved at all in deciding from whom we can buy any legal product. It may be tempting — and publicly popular, despite the costs — to label some products off limits simply because they were produced by people in faraway lands. But it's ultimately myopic. It's a road that unfortunately we've been down before. Trade protections are the last thing we need during this economic downturn.

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John A. Weinberg is senior vice president and director of research at the Federal Reserve Bank of Richmond.

Bond Rating Agencies

Amid the credit market turmoil, many have criticized the bond rating agencies that awarded top-notch grades to securities which are now called “toxic,” as well as the financial institutions that held them. How do these agencies operate? And what do economists have to say about the role they play in a healthy capital market? Before policymakers decide how to regulate the agencies, they might first pause to consider the purpose they serve and determine what may have gone wrong with current regulations.

Silver Screen Subsidies

Legislatures and governors across the nation have started competing to attract movie and television productions to their states. Enticements like tax credits and tax refunds abound. Do these subsidies actually influence a film studio's choice of where to film — and are they worth the cost?

Beeconomics

The decline in the honeybee population caused by “colony collapse disorder” has brought attention to the vital importance of bees to crop pollination. Some honeybee farmers have begun subscriber-funded services to help maintain a sufficient level of pollination. Are markets capable of providing what is seen by some as a classic “public good?”

Airline Crunch

The airline industry has undergone significant changes during the past decade. Recently, airlines have had to deal with a spike in fuel costs and then a decline in demand for air travel. Can the industry survive in its current form?

Jargon Alert

Most people are familiar with what is termed the unemployment rate. We'll explain a lesser known phenomenon: *underemployment*.

Policy Update

Everyone seems to have an opinion about whether CEOs are overpaid. But maybe there's a rational explanation for relatively high executive compensation.

Interview

We talk with economist Allan Meltzer of Carnegie Mellon University, author of a two-volume history of the Federal Reserve and a co-founder of the Shadow Open Market Committee.

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