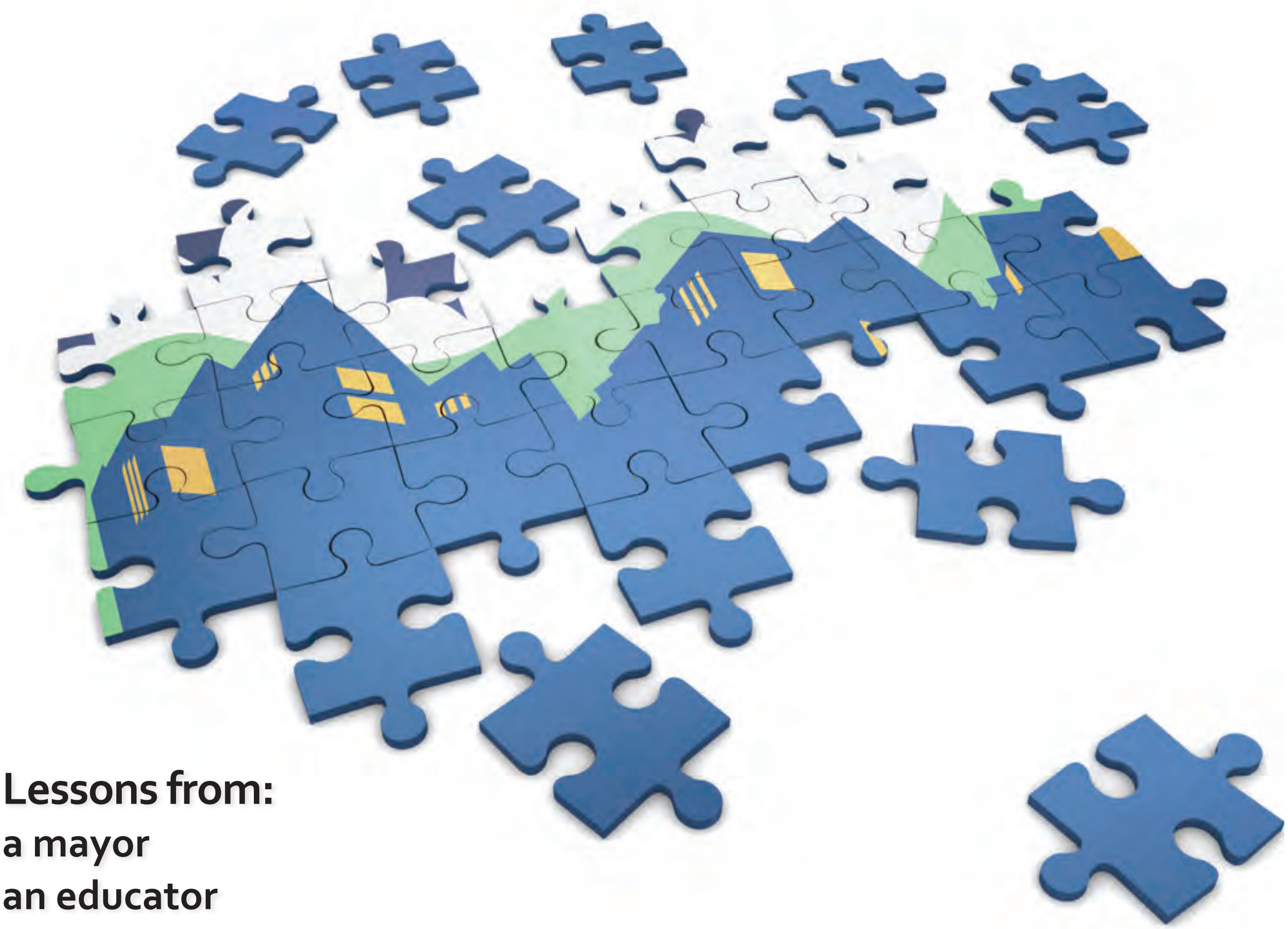
Volume 3 Number 2

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK *of* CLEVELAND

Rebuilding Communities



Lessons from:

- a mayor
- an educator
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Forefront

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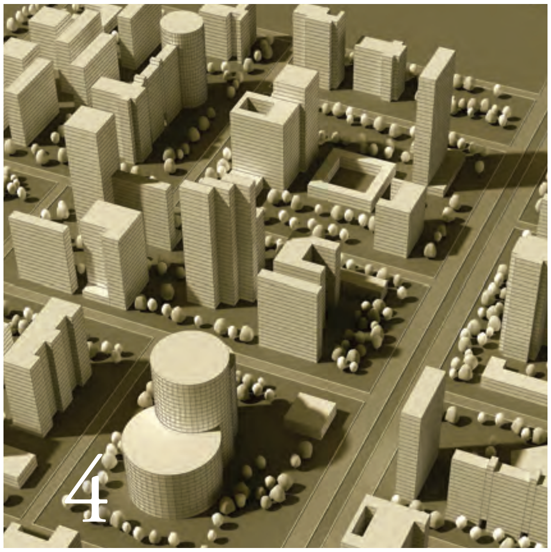

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SUMMER 2012 Volume 3 Number 2

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PRESIDENT'S MESSAGE

Sandra Pianalto
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

Too often, public policies that seem great in theory lose some of their appeal when applied to the real world. At the Federal Reserve Bank of Cleveland, we have sought to bridge that crucial gap from abstract to concrete with our annual Policy Summit. It brings together academics and researchers with community development practitioners, elected officials, bankers, funders, and policymakers to explore economic policy and community development issues. Our 10th annual conference, held this past June, aimed at identifying effective strategies and programs to strengthen and rebuild communities, with a special emphasis on taking a holistic approach to community development.

In this issue of *Forefront*, we highlight some of the marquee sessions from the 2012 Policy Summit. Leading researchers and practitioners discussed new approaches in economic development and education reform. For a useful reality check, public officials from some of the Midwest's largest metro areas explained how they balance extremely tight budgets with the need for long-term community investments. I also encourage you to read the interview with journalist Alex Kotlowitz and visit our website for video excerpts from his moving description of anti-gang violence efforts in Chicago, which put a human face on the stories only hinted at in the data.

A recurring theme in each of these sessions was that public policies are most effective in combination with one another—for example, school reform efforts that acknowledge students will have a better chance of succeeding if they live in stable households, and economic development that takes into account the affordability of local housing or the quality of workforce development programs.

I applaud the Policy Summit's stress on designing programs in ways that will produce credible data for further research and learning. However, we cannot let the quest for perfection keep us from getting off the starting blocks—so we must develop programs in a manner that allows us to test, learn, and make adjustments as we go. We stand a much better chance of doing that if we share information and listen to the many voices involved in community development.

Moreover, the Policy Summit reflects the approach taken by the Federal Reserve in all of our work, which is based on objective research, factual analysis, and broad public input. Every year, I am encouraged to see that there is so much growing interest in exploring new approaches to important issues in community development and public policy. I'm already looking forward to next year's event. ■

Payments System Survives, Thrives During Recent Tax Season

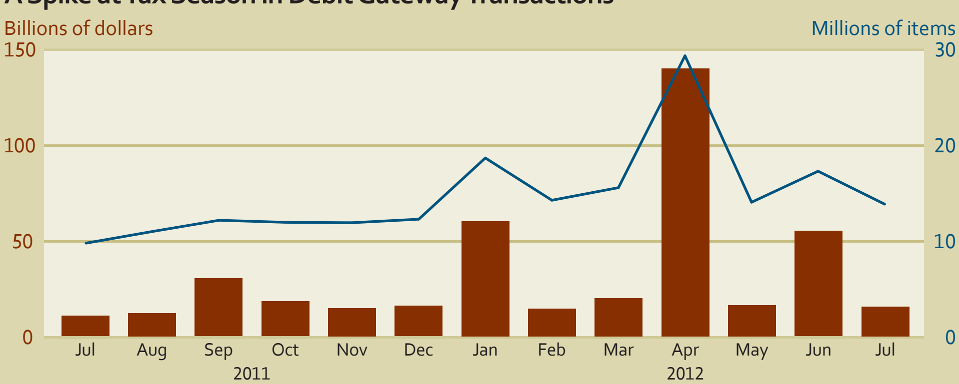
Anne DiTeodoro
Communications Coordinator

A longtime partnership between the U.S. Treasury and the Federal Reserve Bank of Cleveland is expanding in scope, and the payoff could come in the form of reduced government costs.

For the first time, Debit Gateway—the Treasury's payments processing application supported solely by the Cleveland Fed—processed tax lockbox transactions during a tax season.* Debit Gateway has been able to process tax lockbox transactions for quarterly tax payments since mid-2011, when the Cleveland Fed's eGovernment (eGov) function enhanced the software. In fact, from April 2011 to March 2012, it processed an average of 14 million transactions worth $18 billion each month. But it wasn't until this past April that the software enhancements were truly put to the test.

The result: More than 29 million transactions worth a record $141 billion were processed efficiently and accurately during the 2012 tax season, meeting goals for both the IRS and the Treasury. With Debit Gateway, the benefits include increased efficiency in government collection processing and reduced costs in processing received funds.

A Spike at Tax Season in Debit Gateway Transactions



Source: Federal Reserve Bank of Cleveland.

The Federal Reserve System has been acting as a fiscal agent for the federal government for almost 100 years. Today, eGov provides services that include technical solutions. Debit Gateway now enables the System to process a multitude of transactions, including anything from a passport fee to a government-funded small-business-loan payment.

The Debit Gateway process begins as the consumer writes a check or makes an electronic payment. Debit Gateway presents the payment to the bank and credits the appropriate government agency.

Picture a large funnel housed in Cleveland. This is the collection point. Payments from you or me—for anything from a student loan to a national park fee—enter the opening from three points, either over the counter (in person), mail, or online. The payments get "funneled" through the Debit Gateway application and come out as electronic transactions that are then presented to the appropriate banks. From there, the money travels to the government agencies to settle the debts. So, most likely, as consumers, we have all had a Debit Gateway encounter, without even knowing it.

New and higher-volume customers include the Office of Natural Resources, Bureau of Prisons, U.S. Postal Service, and Veterans Administration. By the end of 2012, the Debit Gateway is projected to process more than 20 million transactions per month. ■

* A lockbox is a collection and processing service provided by a third party.

Betting on a Big Impact

April McClellan-Copeland
Community Relations
and Education

Some numbers are in, but it may still take a roll of the dice to determine whether Horseshoe Casino Cleveland, Ohio's first casino, will provide the economic payout that developers had promised.

That's because new tax revenues aren't the only positive expected from gambling—so is spillover business to the city's wider entertainment sector. While we have some tax data already, it will take a while longer to fully register just how successful the Horseshoe has been in driving customers to nearby restaurants and hotels.

From its opening day on May 14 through the end of July, Horseshoe Casino Cleveland grossed $66.5 million after paying out winnings, according to the Ohio Casino Control Commission.

Ned Hill, dean of the Maxine Goodman Levin College of Urban Affairs at Cleveland State University, says it's way too early to tell what type of economic impact the casinos will have on the regional economy. The premise of allowing casinos to operate in Ohio was in part to capture tax revenue that otherwise was going across the border. But of equal appeal is how much casinos help create new energy in the downtown areas where they are being built.

A complex mix of variables are at play, such as whether customers are coming from within or outside the region, and whether the entertainment dollars are being repurposed or shifted from other types of entertainment. Beyond that, the durability of the new casino jobs has yet to be tested, and long-term revenue streams—from which the state takes a bite—are unknown.

Horseshoe officials have touted the casino as a way to pull in dollars not only for itself, but for other downtown businesses.

"This casino [Horseshoe] has a different model from the others," Hill notes. "They are trying to build it into the fabric of the entertainment district." Add it to the Medical Mart, the Rock and Roll Hall of Fame and Museum, and the Lakefront Bikeway that's expanding—the casino is part of that mix.

Horseshoe's adjusted gross income at the end of July, which is the amount left after winnings are paid out, was $23.9 million, an 8 percent drop from one month earlier when the adjusted gross income was $26.1 million.

And the state's second casino, Hollywood Casino Toledo, went from $20.4 million in June to $19.1 million in July. It opened May 29.

Is the novelty of Ohio's first casinos wearing off? Or was this drop in revenue predictable?

"I knew the initial opening attendance would be up and there would be a great deal of interest, and over a period of 90 days there would be some leveling off," says Matt Schuler, executive director of the Ohio Casino Control Commission. "I still believe it will take some time before we get a performance trajectory."

Horseshoe Casino Cleveland, a 300,000-square-foot facility inside the historic Higbee building in downtown Cleveland, offers 2,100 slot machines and 65 table games. The casino brought 1,600 new casino jobs to the region.

Hollywood Casino in Toledo has 2,000 slot machines and 60 table games. It upped the number of new jobs by 1,300.

A casino in Columbus opened on October 8, and one will open in Cincinnati in the spring of 2013. The four casinos were approved by Ohio voters in 2009.

Despite the drop-off in revenue, early numbers from the Ohio Department of Taxation indicate that the casinos' economic impact could be felt across Ohio's 88 counties, where the money is distributed in proportion to the population of each county.

The Ohio Department of Taxation made its first quarterly distribution of $19.7 million in July. The tax money is split between counties, host cities such as Cleveland, school districts, the Casino Control Commission, and other agencies. ■

Rebuilding Communities: Lessons from the Cleveland Fed's 2012 Policy Summit

For 10 years, the Federal Reserve Bank of Cleveland has hosted a unique gathering of researchers and practitioners to talk about community development policies. The 2012 Policy Summit continued the tradition of marrying research and theory with on-the-ground "what works" know-how. Everything from low-income housing programs to workforce development was put under the microscope, and no neat-sounding hypothesis was left unexamined by the practical eye of experience.

In the following pages, *Forefront* zeroes in on the Policy Summit's headline sessions covering economic development and education reform.

For links to a full roundup of the two-day event, including video excerpts from keynote speaker Alex Kotlowitz's moving address, visit us online at www.clevelandfed.org/forefront.

The Shifting Landscape of Economic Development

More cooperation, less corporate subsidization

Doug Campbell
Editor

Economic development used to be easy to define. In its most traditional form, it was designed to motivate businesses to add new jobs, open plants, or move into town. That was about it.

Today, economic development professionals need more space to explain what they do. Their efforts have grown more varied and more interconnected. And they hope their results have likewise grown in magnitude.

"Too much economic development at the state and local levels has been throwing goodies at employers," said Harry Holzer, a professor of public policy with the Public Policy Institute at Georgetown University. "We're talking about economic development that provides some value-added… that works with companies to develop their skill mix, the services the companies provide to employees, and helps them to access the talent they often have a hard time getting on their own."

Holzer joined two other national experts at the Cleveland Fed's 2012 Policy Summit in laying out a new approach to economic development—one that is multipronged, holistic, and long in its planning and execution horizon.

That long horizon is crucial, because returns from investments are often not immediate. On any given day in any given neighborhood, economic and community development professionals are working hard to improve conditions, get people jobs, and make streets safer. Yet for all of their efforts, they face a recurring question: So what?

Here is how Michael Rubinger, president and CEO of Local Initiatives Support Corporation (LISC), framed the problem: "You've developed housing, you've undertaken physical revitalization—but so what? Have you really changed these communities and improved the lives of residents who live there?

If we really are serious about creating sustainable communities, where people willingly come to work and live, we somehow have to address the other daunting issues."

Gone are the days when luring new companies to town was the name of the game. Addressing the needs of low- and moderate-income communities in particular means providing more than jobs—it means providing workforce development opportunities, good schools, safe neighborhoods, access to health care, cultural amenities, housing, and transportation, among other things.

Granted, that's asking a lot. Priorities must be set. LISC's strategy to encompass all of these approaches is called Building Sustainable Communities, and it involves everything from setting up Financial Opportunity Centers to supporting charter schools and after-school programs. But it's difficult to find ways to connect the various organizations with a common mission, Rubinger said. School officials have enough on their plates without coordinating with local housing authorities, for example. But Rubinger emphasized the strategy is not—and cannot be—about the individual projects, no matter how effective or innovative they may be.

"It's about how these are woven together in a mutually reinforcing way in a single, targeted neighborhood to achieve greater force and impact," Rubinger added. This year, LISC is active with such efforts in 50 communities across the country. The current slow economic recovery is only adding to the challenge, making it harder to raise funds and reverse economic decline. "We're making progress, but let's be clear—our work has only just begun."

A localized experiment in comprehensive economic development is happening in Akron, Ohio. Eric Anthony Johnson, executive director of the University Park Alliance, described plans to transform the 50 blocks around the University of Akron into an economically, socially, and culturally vibrant community. Anchored by the university, a medical center, and three primary education schools, the plan looks to create more than 2,500 jobs over the long term.

In the University Park Alliance's strategy, commercial development projects go hand in hand with neighborhood revitalization. A company considering a business investment in the region may be more willing to do so if it sees a healthy neighborhood with a built-in, skilled labor pool. And for families and individuals, the decision to move to the community may likewise be based on nearby employment prospects.

"The old economic development model is throwing out a fishing pole and hoping to land the big company," Johnson said. "That doesn't happen now. Our emphasis is on place."

Both the LISC and the University Park Alliance approaches aim to break institutions and organizations out of their traditional silos. Holzer noted that overcoming the inertia of institutions is difficult because they often lack incentives to change. Historically, for example, the U.S. Department of Education has not always tried to align its policies with the Labor Department's workforce development programs.

Students may get a decent education in public school, but they may still lack basic information about the most in-demand skills and occupations in the labor market. And when they do recognize opportunities, they often can't get the education they need.

"We have all these stories during the recession of unemployed workers going back to college, community colleges especially. They knew that health care and health technology remained a strong field despite the recession," Holzer said. "And the classes were always oversubscribed because the institution didn't have the incentive to expand capacity in those high-demand areas. That's part of the problem of education and workforce not being integrated and the two of them not being responsive to the demand side of the labor market."

The old economic development model is throwing out a fishing pole and hoping to land the big company. That doesn't happen now. Our emphasis is on place.

What works, Holzer said, are some of the very approaches taken by LISC and the University Park Alliance. Local schools must connect with one-stop workforce development shops that are in turn connected to local employers. Good data will help identify where the jobs are located and which sectors are growing. And intermediaries are essential to bring together the industries, the associations, the employers, the training providers, and the workers. Above all, the strongest returns come when educational programs match labor market needs.

The first step is simply recognizing the need to make connections—that the kind of housing one lives in has a direct correlation with how well children do in school; that just because a factory moves to town doesn't mean qualified candidates have access to transportation that would bring them to the workplace. Silos must be broken down.

"The implication for community development," Rubinger said, "is that we have to be comprehensive in our approaches."

The next step is arguably harder. That's when results have to be produced—when you have to answer the "so what" question. ■

Watch video clips from this session
www.clevelandfed.org/Forefront/2012/summer/ff_2012_summer_06.cfm

Working Out an Equation for Education Reform

Cutting-edge efforts to improve America's education system

Anne O'Shaughnessy
Community Development
Project Manager

Education reform prompts no shortage of heated policy debates. Do teacher incentives work? Are charter schools delivering better results than public schools? Will U.S. children fall further behind their global counterparts if we don't push more math and science? And how important is the role of early childhood education?

Not in dispute is that education is a critical component of a strong economy. A wide body of research, including some by economists at the Cleveland Fed, shows that better educational outcomes contribute to greater individual earnings potential, a stronger workforce, lower rates of incarceration, and stable neighborhoods and communities —all of which drive a strong regional economy. That's why efforts to improve America's education system took the spotlight at the Cleveland Fed's 2012 Policy Summit.

The big question is this: What public policies can best promote better schools and improved outcomes? As with many complex issues, there is no one-size-fits-all solution. Budget constraints are among the many challenges facing school districts and education policymakers across the nation. Researchers at the Policy Summit delivered several messages, none clearer than the recurrent theme that "evidence matters."

"It's important not only to evaluate research, but also to engage stakeholders in using and generating evidence," said Rebecca Maynard, Commissioner, National Center for Education Evaluation and Regional Assistance at the U.S. Department of Education's Institute of Education Sciences (IES).

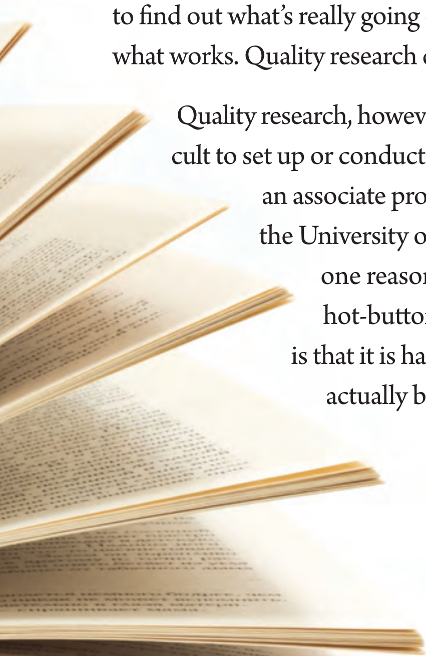
Determining what's most useful to educators and policymakers has been the work of IES, which in 2002 developed a database of educational research on policies and programs it evaluates based on stringent criteria. To date, some 6,500 studies have been reviewed; 6 percent meet IES standards. IES shares this scientific evidence on its website along with practice guides that offer a more practical, applied resource for educators in the classroom. "We want educators to be able to make evidence-based decisions about, for example, what content to teach," explained Maynard.

IES also provides research-based training on tactics for classroom management, strategies for retaining and motivating teachers, and techniques for classroom instruction, all aimed at helping teachers and school administrators improve student outcomes. To ensure consistency and efficiency, regional representatives work with other government agencies to create a single portal for educators to learn about these opportunities.

But what works in one district or with one set of students may not work elsewhere. New programs are developed all the time based on research, anecdotal evidence, and the passion of educators and parents. Many show promise, but which ones are worth funding? Trying them is not a bad investment, said Maynard, provided there are clear measures built in to assess whether they work, and how well.

Kimber Bogard, from the Institute of Medicine at the National Research Council, shared evidence on the value of early childhood programs. She pointed to certain aspects of early childhood programs that research shows are working. "Quality of program matters," she said. "Teacher quality matters. And mobility and absenteeism matter." She also advocated for greater collaboration among researchers, social scientists, child development specialists, and economists. You can't look at education policy from a single perspective—whether the child's, the educator's, or the taxpayer's. "You need a more comprehensive approach to find out what's really going on," she noted, "and to learn what works. Quality research depends on it."

Quality research, however, can sometimes be difficult to set up or conduct. Panelist Susan Dynarski, an associate professor of public policy at the University of Michigan, explained that one reason charter schools are such a hot-button issue in education reform is that it is hard to tell whether they are actually better than public schools.



Nevertheless, the lottery system that many charter schools employ to enroll students provides researchers with a decent randomized trial sampling. The results from one study show statistically significant numbers that charter schools can make a positive difference. More research must be done, she added, before any conclusive assessments can be made. That goes for just about any program, she said: "Make sure you're driving with the headlights on."

One conclusive finding Dynarski pointed to is the growing inequality among students with a bachelor's degree and those without. Where can policy changes help? And how? Maynard said policy ought to be driven by science, though she acknowledged that in reality it is driven by many other things, such as budget constraints, public sentiment, and competing political interests. "If I could change one thing, I would stop rolling out big things—like teacher value-add [a method of teacher evaluation]—without building in science to learn from it," Maynard said. "Policy changes should be more incremental."

If I could change one thing, I would stop rolling out big things… without building in science to learn from it.

Timing is important, too. Noted Dynarski: "Invest in the right programs that work, of course, but it's also important to know when—at what point on the timeline or education continuum."

Finally, no policy or program exists in a vacuum. "It's never just the classroom or the neighborhood," the National Research Council's Bogard said. "Families, too, are essential for successful outcomes." Education reform is one piece of the puzzle, and it may be more effective when interconnections with other efforts are recognized.

"When you're talking about schooling, you're talking about kids, you're talking about a school, you're talking about teachers, you're talking about a workforce, you're talking about a system," Bogard summed up. "Working together is going to give you the biggest bang for your buck." ■

Want to learn more?

Check out the Institute of Education Science's evaluations of thousands of education reform efforts at ***www.ies.ed.gov/ncee/wwc***

Watch video clips from this session

www.clevelandfed.org/Forefront/2012/summer/ff_2012_summer_07.cfm

FEDERAL RESERVE BANK of CLEVELAND 2012
POLICY SUMMIT

The New City

Some practical lessons about policy implementation from city (and county) hall

Amy Koehnen
Managing Editor

Many cities are fighting for survival in a post-recession, still-feels-like-a-recession economy. Against the backdrop of dwindling tax revenues and lean budgets, just keeping the trains running has become a challenge. Long-term planning to address chronic unemployment, improve human services, and reform the education system increasingly has to take a backseat.

That tension between the daily-grind reality of running an American city versus high-minded, future-oriented community development was the focus of a special panel at the Cleveland Fed's 2012 Policy Summit. Leaders from three major Midwest metro areas—Cleveland, Pittsburgh, and Cincinnati—talked about the difficulty of balancing short-term necessities with long-term planning, and how tough budgets are forcing them to make even tougher calls.

"How to do more with less" has become the motto of many local governments. Before the financial crisis, hundreds of millions of dollars streamed in from both the federal and state governments. Historically, those were localities' main funding sources for certain projects, "where you have to generate the money to do the big brownfield cleanups, infrastructure improvements," and other projects to revitalize cities, said Rich Fitzgerald, chief executive of Allegheny County, Pennsylvania. Likewise, roads, bridges, mass transit, and airports have all traditionally used state and federal dollars that are no longer available. Those dollars have dried up.

Another emerging problem: Some of today's fastest-growing employers tend not to contribute so much in the way of tax revenue.

Take downtown Pittsburgh. It's one of the most booming urban areas in the country, according to Fitzgerald, thanks in large part to its two research universities—the University of Pittsburgh and Carnegie Mellon University, along with its medical centers. But these institutions are nonprofits that do not pay property tax. "For most cities," said moderator Tom Murphy, the former mayor of Pittsburgh now with the Urban Land Institute, "we are forced to try to make something work in a box that is unworkable."

With less money to work with, cities need to innovate to position themselves to succeed in the future, all the while taking care of today. Cleveland Mayor Frank Jackson summed up the panelists' strategy this way: You have to plan for good times and for bad times. When the hard times come, he said, it's too late. Jackson said his administration had already made a lot of hard cuts before the 2008 financial crisis, trimming anything not deemed critical. As a result, he said, Cleveland's landing was softer because the city had planned for it. It was still hard, Jackson admitted, but because the city wasn't forced to tap money set aside for investments in the future, it was better positioned to take advantage of improving conditions.

Roxanne Qualls, Cincinnati's vice mayor, echoed Jackson's sentiments. In Cincinnati, as in Cleveland, the mantra is to have a structurally balanced budget. But she argued that while budgets have been cut—slashed, even—there seems to be "a lack of will on the revenue side." The city reduced the workforce by 1,000 people, but Qualls still sees a lack of investment in some of Cincinnati's neighborhoods.

Cincinnati's solution is twofold: 1) building a new "priority-driven budget" by working with communities on setting priorities for expenditures, and 2) establishing a tax commission to look at how tax policies grow or inhibit jobs. Results, Qualls said, should be in by the end of the year.

Allegheny County's Fitzgerald made a novel observation: Tax rates aren't as important to businesses as they are made out to be. It's a myth, Fitzgerald said, that if you cut taxes, businesses will come to your community. "Companies rarely say that that is what they want. They want help with training employees. 'Can you provide better transit for our employees to get to work? We need an off-ramp to get goods and services in and out of this community.' But day after day we see politicians signing pledges to never raise taxes [on businesses]. It's shortsighted and goes against good governance."

from l-r: Roxanne Qualls, Vice Mayor, City of Cincinnati; Rich Fitzgerald, Chief Executive, Allegheny County (PA); The Honorable Frank Jackson, Mayor, City of Cleveland; Tom Murphy, Senior Resident Fellow, Urban Land Institute

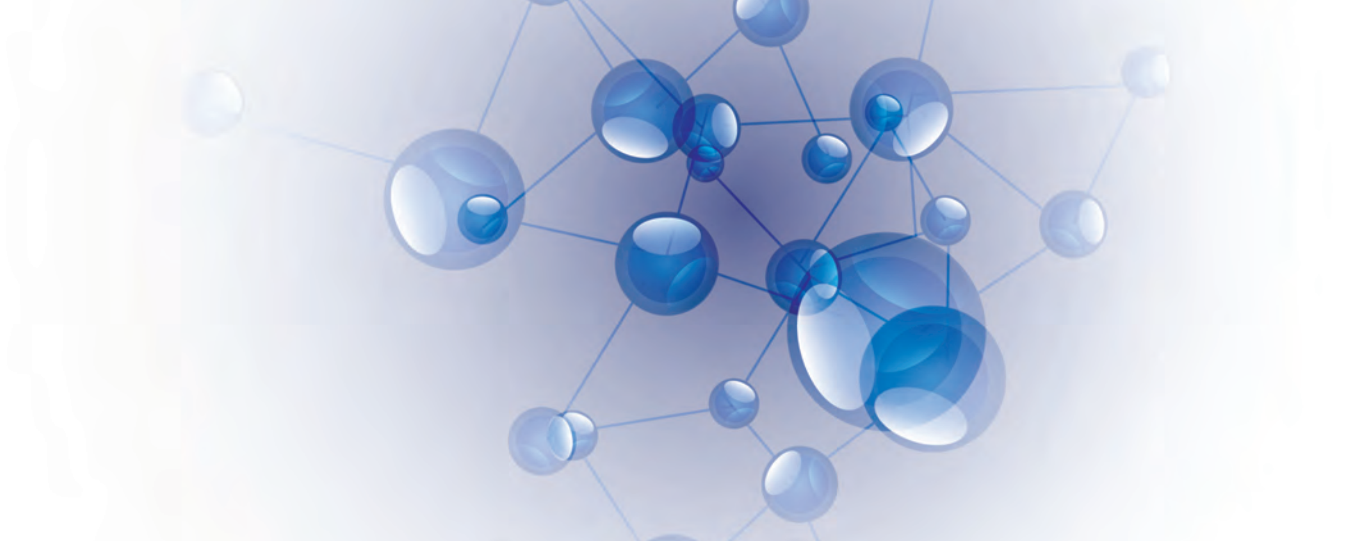
It's a myth, Fitzgerald said, that if you cut taxes, businesses will come to your community.

The main issue, as Fitzgerald sees it, is that leaders simply "haven't restructured for a new city and region." As the manufacturing sector fades in relative dominance, new industry–government partnerships need to be formed. "We still have manufacturing, but we've diversified," Fitzgerald said. "We have information technology, life sciences. We make movies." He also pointed to the area's success at spinning off the research initiatives into companies and into jobs.

Moreover, even during times of belt-tightening, there is room for forward-looking projects. One of Cincinnati's most promising developments is happening on its riverfront, where a series of public–private investments has created a bustling retail and entertainment district. Elsewhere in the city, partnerships with universities and hospitals in the Uptown neighborhood have produced new efforts to improve human, social, economic, and physical conditions in the area. And a newly created innovation task force is trying to help spin more commercial ventures out of the world-renowned Cincinnati Children's Hospital Medical Center.

But why encourage these types of institutions to grow when they don't directly contribute to the region's tax coffers? Because indirectly, they do.

The key is the "connectivity between the institutions," Jackson said. "If this happens in the right way, it offsets what they don't pay in property taxes because you grow an economy. Our hospitals … procure billions of dollars in goods and services each year. The more it can flow into our economy, the more it can support local business, and the more people will stay employed." ■



Getting to the "How" of Innovation

Innovation—everyone is for it. In fact, one of the most firmly established principles in economics is the importance of innovation in driving growth and prosperity. The ability to produce knowledge and use it commercially is the main determinant of whether—and how well—nations and regions thrive.

Yet *how* to drive innovation remains elusive. We really don't know much about the production, diffusion, and application of knowledge. At the same time, economics is pretty good at providing some rules of thumb—many of which, unfortunately, tend to be ignored. With that in mind, *Forefront* asked some economic experts for their take on how best to capture the fruits of innovation.

Doug Campbell
Editor

Why innovation is important for growth

Let's start with the question of how we know that innovation powers economic growth. This key insight came from Nobel economist Robert Solow, who found that standard economic models failed to account for almost half of the economy's output. There was something beyond the accumulation of physical capital—a residual that most people now ascribe to technological innovation. We at the Cleveland Fed have defined it as "finding a better way to get things done with what you already have."

Over the years, economists have refined Solow's growth theory to clarify the role of technological innovation. Real-world evidence on the importance of innovation is also mounting. Looking over a 75-year period, Cleveland Fed economists and their co-authors have found that patents were the single largest factor explaining income differences across U.S. states. High levels of patents in states like Connecticut, Massachusetts, and New Jersey explain most of their income growth going back to 1939. This implies strong innovation and knowledge-building in places with vigorous income growth. Overall, our economists concluded, innovation is the most important factor in determining people's welfare.

Why we think policies can help innovation

Once we understand the importance of innovation, the next logical question is whether public policy can help raise innovation levels. Our nation's go-to policies include tax credits for research and development, robust patent protections for innovating firms, grants and subsidies to entrepreneurs and academic researchers, and so on. Are they working?

According to Andy Atkeson, an economist at the University of California, Los Angeles, and a visiting scholar at the Minneapolis Fed, the litmus test for most economists is whether the free market would drive innovation more efficiently than government policy. After all, the main reason firms might want to innovate is to boost their profits. If firms are going to innovate anyway, why should the government step in and risk distorting the market?

The answer is that firms may not invest in innovation as much as the rest of us would like. That's because, as Atkeson notes, the benefits of innovation don't flow just to the innovators. Society gains as well.

Ideas generally can't be stopped from spilling over into the wider world, and firms learn from each other. In fact, it's the social element of innovation that makes it beneficial to the wider economy. To take a classic example: Synthetic fiber was invented in the chemical industry, but the knowledge that created it spilled over to the textile industry.

Atkeson offers a more recent example: "Apple's investment in R&D has been amply rewarded in the company's profits. But they can't patent the market categories they created, like the smartphone. They showed people what it should look like, and now lots of others are copying it. That means they didn't get the full return from their investment. In the end, there is a big intellectual component from innovation that's not captured by the innovator."

The very existence of knowledge spillovers suggests that we might not be getting as much from them as we could. All the same, economists strongly suspect that companies will invest in research and development only to the extent that they can profit from it. The part that spills over is extra, not something they factor into the equation.

But from a societal standpoint, we want as much of the innovation spillover as possible. That's where policy can make a difference.

Why innovation is so important right now

The nation's struggle to claw back from a severe recession would be motivation enough to think about ways to boost innovation. But another motivation comes from the long-run trend of productivity growth — in the wrong direction. As economist Tyler Cowen explains in his 2011 e-book, *The Great Stagnation*, America has enjoyed a long period of picking low-hanging fruit, in the form of new technology to fuel a fast-growing labor force. But since the 1970s, the lowest branches have become increasingly bare. "That's a sign that the pace of technological development has been slowing down," Cowen notes. "It's not that something specific caused the slowdown, but rather we started to exhaust the benefits of our previous momentum without renewing them."

The litmus test for most economists is whether the free market would drive innovation more efficiently than government policy.

You can see the stagnation in productivity data. Since 1973, the rate of productivity growth has fallen below the trend in the post–WWII period.

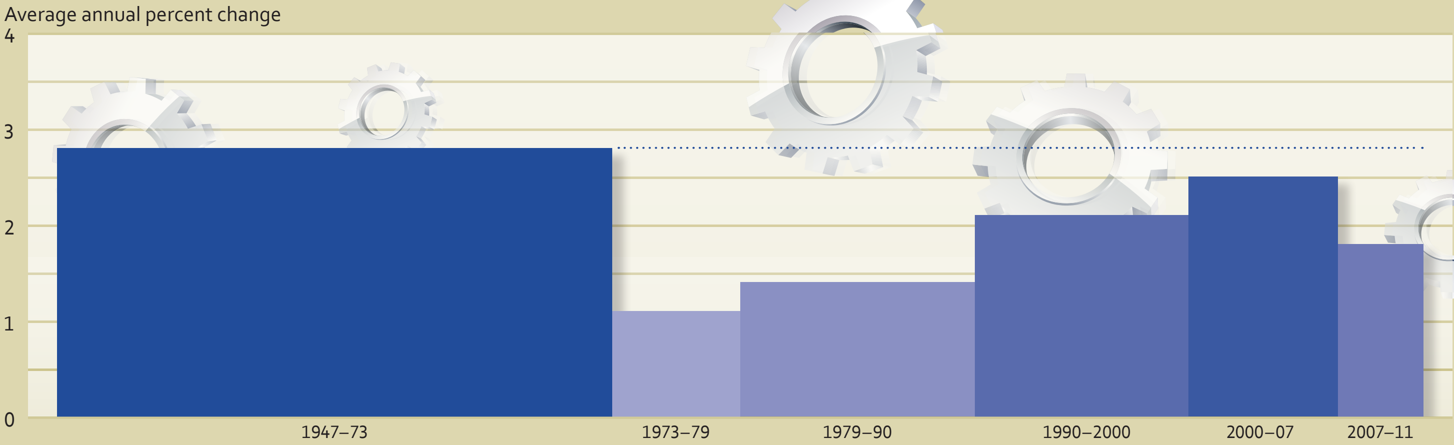
The starting point

Innovation is not a linear process; it's messy and iterative. Ideas bop around until they are fine-tuned into something with real market value. Failure is a key part of the process.

For that reason, there seem to be many potential entry points where policies can affect innovation. These begin with ***basic research*** — the most fundamental stage of innovation, where ideas are beginning to germinate and most likely have no specific commercial use in mind. Then there is ***applied research***, in which commercial entities transform ideas into prototypes and processes. Also crucial is ***funding*** — entrepreneurs need financial backing to get their ideas into development and production. ***Intellectual property rights and associated patent protection policies*** are also important. And of course, ***educational institutions*** perform a number of roles, from idea and business generators to workforce preparation.

Scott Shane, *BusinessWeek* blogger and economist at Case Western Reserve University, suggested where innovation policy could be most useful.

Productivity Change in the Nonfarm Business Sector, 1947–2011



Source: U.S. Department of Labor, Bureau of Labor Statistics.

You can see the stagnation in productivity data. Since 1973, the rate of productivity growth has fallen below the trend in the post–WWII period.

The starting point, Shane believes, is weighing the costs and benefits. Often, he says, it's not clear that policies aimed directly at firms would create better outcomes than the private market would on its own. In other cases, it seems that the government provides windfall subsidies beyond the point where companies would have invested otherwise.

"It's very hard to link what economic developers are saying should be done to some specific evidence of what would work," Shane explains. "Why should we advocate policies to create innovations if we don't even know whether they work?"

Innovation "maybe nots"

With that yardstick in mind, here are the innovation policy staples that some economists have identified as needing careful cost–benefit analysis.

Incubators are a favorite "innovation-friendly" government program. Incubators typically feature a building whose small-business tenants share space, computer and office equipment, and onsite counsel. Putting innovators in the same place, it is hoped, will encourage them to swap ideas, contacts, and funding sources. The same principle is behind the notion of agglomeration—the idea that people and firms working within the same region increase their ability to share and profit from knowledge.

The National Business Incubation Association counts about 1,200 business incubators across the country. Many are supported by local governments and universities.

The way Shane sees it, you most often end up with promising young firms that choose to operate in the incubator because they can get free or inexpensive space. The clustering and specialization that firms can experience as part of an incubator can help their performance. He wonders, "If the private sector benefits from providing space for new firms, why doesn't it do it?"

Direct financial subsidies to companies are premised on the theory that young firms in particular don't have the resources to engage in serious research and development on unproven ideas, and they can't attract investors in their very early stages. Subsidies can take the form of grants or loans, sometimes funneled through public venture-capital funds. Local policymakers often use multipliers to justify these investments, arguing that every $1 invested turns into a certain number of new jobs, for example.

The problem with the direct subsidies approach, several economists contend, is that it may distort market outcomes. The government could get itself into a situation of picking winners and losers, and prematurely at that.

Private markets are much better at sorting out winners from losers than anyone trying to foresee which idea may eventually gain traction.

Patent protection, counterintuitively, may sometimes stifle innovation. This is the argument made by George Mason University's Alex Tabarrok, author of *Launching the Innovation Renaissance* (2011). Patents are supposed to reward innovators by handing them a monopoly on their product for a certain number of years. Profit-seeking investors will be more likely to put their money into projects they think will be insulated from competition, the thinking goes. Patent protection certainly makes sense in situations where the costs of innovation greatly exceed the costs of imitation—like the pharmaceutical industry.

But Tabarrok sees too many situations in which patent protection is overused. The problem is particularly acute with innovations that produce intermediate goods, that is, goods that are used to produce other goods and innovations. Tabarrok's example is the "oncomouse," a genetically engineered mouse used in biomedical research. For years, he says, Harvard and DuPont wielded virtual control over the oncomouse, even though others could have greatly enhanced biomedical research with access to it. The upshot was that strong patent protections increased the cost of building on previous research and thus discouraged further innovation.

"The patent system is now being used as a weapon for innovative firms to attack other innovative firms and slow them down," Tabarrok said.

The tax code is a critically important consideration in innovation policy. To Atkeson, the tax code is in fact the *most* important consideration because it bears so directly on whether entrepreneurs choose to enter the market.

Consider the offsetting effects of the U.S. tax code on research and development tax credits. R&D credits were established in 1981 as an incremental subsidy—a tax credit to supplement a defined base amount of spending. In recent years, the value of the subsidy has ranged between $4 billion and $8 billion a year. A 2009 Government Accountability Office report found that the R&D tax credit reduced the business costs of new research by about 7 percent. The GAO also noted a number of shortcomings in the R&D tax-credit system, including disparities between the amount of the credit and its actual incentive effects.

But there is a wider issue to consider: Any innovation-investment payoffs will be counterbalanced by the taxes businesses will pay on their profits. Atkeson explains it this way:

> When you're considering creating a new firm, you tally up all the revenue you think you can make versus the expenses. That includes projections of a subsidy for innovation that you might get, as well as payment of corporate taxes on profits. As anyone who evaluates business plans knows, if the present value of your investment is positive, you should enter. If not, you shouldn't. So, from a purely business plan perspective, a subsidy is dollars coming in and taxes are dollars going out. I would think those two policies would just cancel each other out. But in fact, our research has found that they don't cancel each other out, because the corporate tax is bigger than the subsidies!

So the discouragement of entry that we have with the corporate tax is much larger than the encouragement of innovation with the R&D tax credit.

"If policies discourage entry, that's not good," Atkeson said. "The rule should be to evaluate the universe of policies based on whether they affect an entrepreneur's decision to enter."

The discouragement of entry that we have with the corporate tax is much larger than the encouragement of innovation with the R&D tax credit.

Innovation "do's"

Just as economists have reservations about certain policies, they are enthusiastic about others. These include:

Investment in basic research. The federal government is the main source of funding for basic research, which is mostly conducted at academic institutions. Meanwhile, according to the National Science Board, only about 3.8 percent of industry-sponsored R&D can be classified as basic. The federal government's annual contribution is about $37 billion of the $62 billion total spent on basic research in the United States.

Experts agree that when it comes to spurring long-term innovation, the federal government should do much more investing in basic research, which is the lifeblood of innovation. Basic research increases the technologies that lead to new industries and new products in the future.

We ought to grab up smart people who want to come here, and do it now when they still want to come.

The internet is Exhibit A. Without coordinated effort and investment by federal agencies in the 1960s and 1970s, the internet infrastructure never would have been built. Most of these dollars went directly to universities and research institutions, well before it was clear that the "packet switching" technology dreamt up at MIT would blossom into the internet of today.

"The best way policymakers can fund basic research is through government labs or to support academic research," Shane contends.

Improve education. To bring ideas from the lab to the marketplace requires more than a single genius. But in a country where one of every four American men doesn't even graduate high school, access to that help is a challenge.

Tabarrok advocates a range of efforts to improve educational outcomes that drive innovation. These include rewarding good teachers, creating more vocational educational programs and apprenticeships, and encouraging more students to go into math and science fields.

A body of other research points to early childhood education as a potential source of fuel for innovation. As Art Rolnick, co-director for the Human Capital Research Collaborative at the University of Minnesota, puts it, "Early childhood education is economic development, and the research shows it's economic development with a high public return — very high."

Let high-skilled immigrants work here. Another way to improve the labor force is to open our doors more fully to high-skilled immigrants. As Tabarrok argues, the United States has a workforce of 150 million but annually allows only 120,000 employment visas. And each country has a limit on the number of immigrants allowed each year, regardless of the needed skills.

Tabarrok describes this as low-hanging fruit with an expiration date. Wait too long to change policy, and eventually conditions will improve in the immigrants' home countries to the point where they have little incentive to emigrate. "We ought to grab up smart people who want to come here, and do it now when they still want to come."

Ken Simonson, chief economist of the Associated General Contractors of America, agrees, saying current U.S. immigration policy sends a mixed message: "We welcome students from abroad into our science, engineering, and technology programs, and then we say, 'Sorry, we don't want you working here.' That's just at the point when they could be our innovators!"

Don't forget the private sector

Beyond these policy recommendations, where does the private sector fit in? Eugene Fitzgerald, an engineering professor at MIT and formerly a scientist at AT&T Bell Labs, brings a perspective from the trenches. He invented something called "strained silicon electronics," a way to improve the performance of integrated circuits that was a huge technological advancement.

The interaction between corporate and public America was central to this process, in Fitzgerald's telling. Back in the 1950s and 1960s, he says, the back-and-forth between corporate labs, government labs, and university researchers was robust. Ideas were swapped and knowledge spread to benefit end users.

Today, large corporate labs have largely disappeared. They went away, Fitzgerald says, because global competitors sprouted up to take on the virtual monopoly firms in the United States. For example, Kodak suddenly had to deal with Fuji, and pressure shifted to maintaining short-term profits. Before, big U.S. firms could wait a decade for a return on their research investments, but that's too long in today's hypercompetitive environment.

With mainly government and university research left to carry the load, the crucial feedback loop with the private sector was severed, and innovation became less efficient. Fitzgerald cites this trend to explain the drop-off in productivity growth starting in the 1970s.

Fitzgerald sees the absence of corporations from the innovation pipeline as contributing to an "innovation gap" that slows the overall pace of innovation. The innovation pipeline may currently produce a lot of research and patents, he says, but not a whole lot of economic growth.

Figuring out the mechanism for bridging the gap is another matter. Theoretically, the R&D tax credit should induce long-term investment in innovation. Fitzgerald says he is working on an index that measures "innovation capacity" in a company. The IRS could eventually use this metric to confirm tax credits are being properly channeled to long-term investments.

"There is no way the free market alone can get corporations to invest 15 years out," Fitzgerald adds. "You need long-term government funding. They're the only ones who can recover their investment over the long term, because they get it back in tax revenues and growth."

The waiting is the hardest part

The final ingredient in spurring innovation in America may be patience. All of these efforts will take time before any return is evident. In today's results-now world, waiting a decade for the payoff seems like an eternity. Politically, a multipronged approach to increasing innovation would probably have to survive at least two presidential administrations and several more Congresses.

The challenge is to create linkages between our long-term innovation goals and the short-term needs of the institutions that play a part in the innovation process. It's a lot simpler to articulate that challenge than to actually address it.

Fortunately, the stakes are high enough to give policymakers plenty of incentive to make it happen. The future of innovation depends on their determination. ■

Resources

Find links to readings mentioned in this article at ***www.clevelandfed.org/Forefront/2012/summer/ff_2012_summer_05.cfm***

Find links to Alex Tabarrok's 2011 book, *Launching the Innovation Renaissance*, and related materials at ***http://marginalrevolution.com***

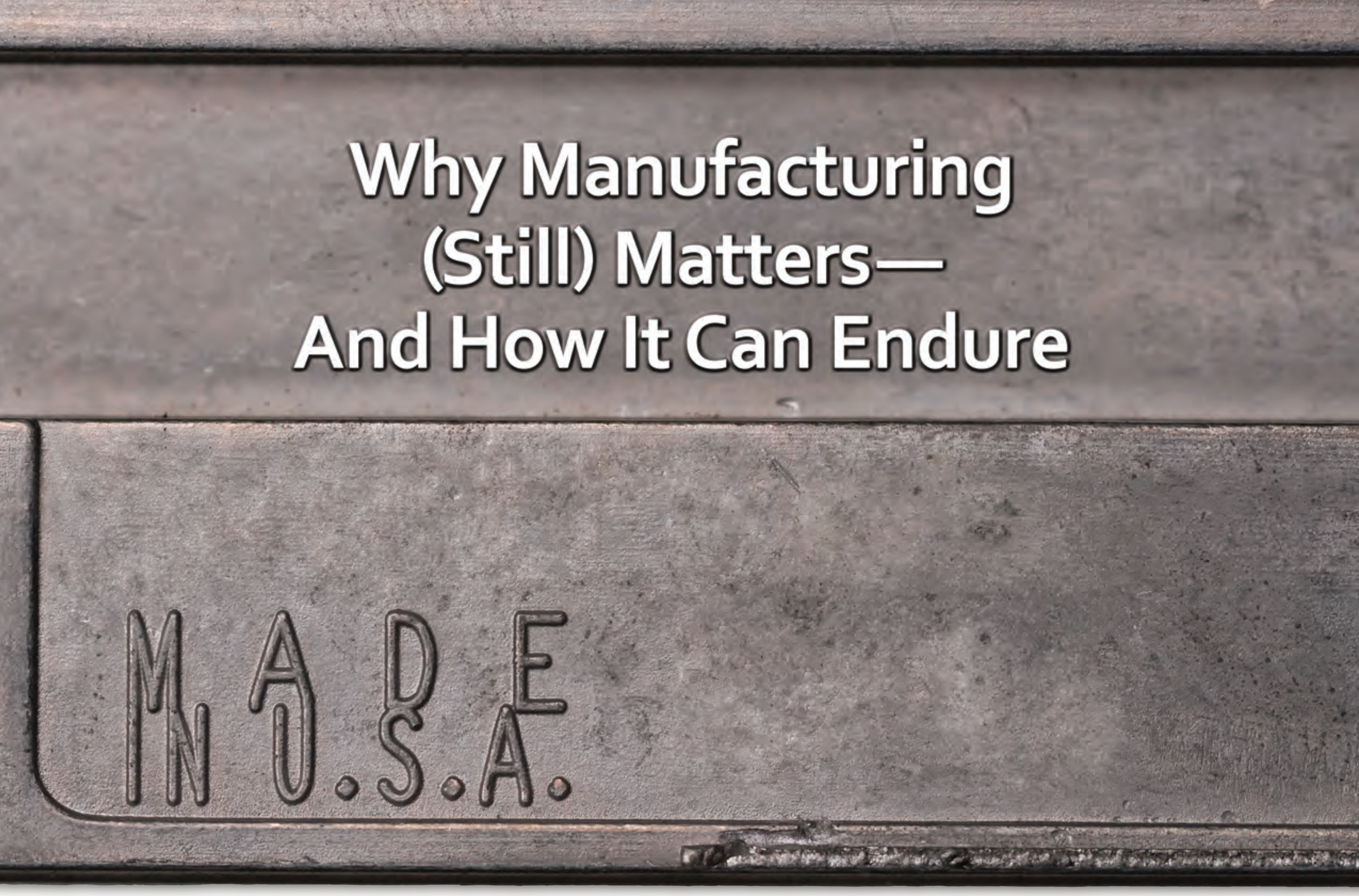
Read columns on innovation and entrepreneurship by Scott Shane at ***www.businessweek.com/authors/2250-scott-shane***

Recommended reading

Andrew Atkeson and Ariel Burstein. 2011. "Policies to Stimulate Innovation: How Effective Are Policies to Encourage Investment in Innovation by Firms, and What Impact Do They Have on the Macroeconomy?" Federal Reserve Bank of Minneapolis Policy Papers (October). ***www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4752***

Eugene Fitzgerald, Andreas Wankerl, and Carl Schramm. 2011. *Inside Real Innovation: How the Right Approach Can Move Ideas from R&D to Market—And Get the Economy Moving*. World Scientific Publishing Company. Also, find a synopsis on *Inside Real Innovation* at ***www.forbes.com/sites/ciocentral/2011/01/31/why-the-government-needs-to-invest-in-innovation/***

Why Manufacturing (Still) Matters— And How It Can Endure



Kyle Fee
Senior Research Analyst

In 1960, the manufacturing sector employed about one of every four Americans. Today, it's one of every 10. In terms of nominal GDP, manufacturing has gone from driving 25 percent of the economy to less than half that over the past 50 years.

These trends raise a natural question: Does manufacturing still matter in the U.S. economy? The answer, supplied at a recent conference held at the Federal Reserve Bank of Cleveland, is a solid "yes," though it comes with some interesting wrinkles.

While it may never provide the employment base or comprise the share of GDP it once did, U.S. manufacturing seems positioned to remain a vital part of the economy for the foreseeable future. That forecast, however, depends on whether the country can implement policies to address potential problems and capitalize on current strengths.

The views expressed in this article were largely gleaned from presentations at the May 30-31, 2012, industry conference, Making It in America: Manufacturing Matters, co-sponsored by the National Association for Business Economics and the Cleveland Fed.* The conference focused on the changing dynamics and rebalancing of U.S. manufacturing industry in the global economy.

* Anything not directly discussed at the conference is attributed to other sources.

Here are four questions that permeated conference discussions:

1 Why won't manufacturing be the major employer it once was?

It's no secret that the United States has lost manufacturing jobs to the offshoring of production processes to countries with low labor costs and a large population of low-skill workers. Low-skill, labor-intensive jobs are inherently mobile, and many of them will never return to the United States because it is simply unprofitable to locate those jobs here. We see this dynamic playing out across the globe as companies readily move production facilities from country to country in search of lower costs.

Take China, for example: previously a reliable source of low-cost labor, the country has seen labor costs rise markedly over the past decade. According to the Bureau of Labor Statistics (BLS), Chinese wages increased 100 percent from 2002 to 2008. As recounted in a recent article in the *Economist*, rising wages in China have spurred the movement of some jobs to other lower-cost Asian countries.

Global trade and competition have also affected U.S. manufacturing. Comparative advantages make certain manufacturing activities more productive in other countries. So when firms from different countries compete in the global market, the firms that can best take advantage of the strengths of a certain location will be successful, and the less strategic ones will close, with their resources reallocated to more productive uses.

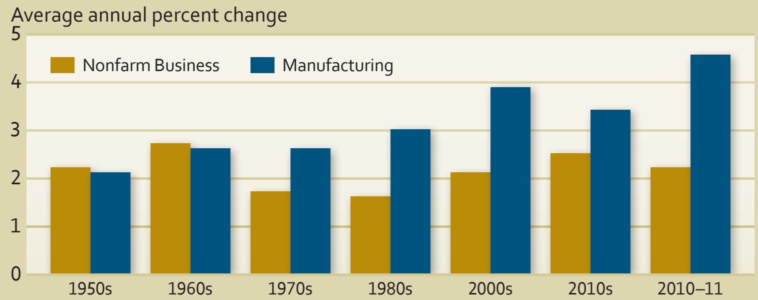
It is easy to conclude that when domestic companies move production facilities overseas, it is with intentions of importing back into the domestic market. However, it is more a reflection of the companies' interest in participating in the global market than in exporting back to the United States. Total world sales by foreign manufacturing affiliates have increased by $1 trillion from 2000 to 2009, while sales to the United States have remained stagnant at roughly $200 billion, according to the Bureau of Economic Analysis (BEA).

The real smoking gun for why manufacturing will not provide the employment base it once did is directly tied to the industry's own success in improving productivity. It now takes only 170 workers to produce what it used to take 1,000 workers to produce in 1950, according to the BLS. Technological advancements to control costs as well as to improve product quality have increased productivity.

This remarkable increase is analogous to the agricultural sector's performance during the 20th century. Farm employment declined dramatically even as output shot up. While much of the advancements in farming happened earlier in the century, manufacturing saw its largest upticks in productivity beginning in the 1970s, as new technologies began to be incorporated into production processes.

Within the manufacturing industry, productivity increases were especially pronounced in the production of durable goods over the last 30 years, thanks in part to the adoption of such process-improving technologies as Computer Numerical Control machining tools and AutoCAD. Moreover, as technological advances have continued to accrue, manufacturing productivity has continued to outpace productivity gains for the larger economy.

Productivity, Thy Name is Manufacturing



Source: Bureau of Labor Statistics.

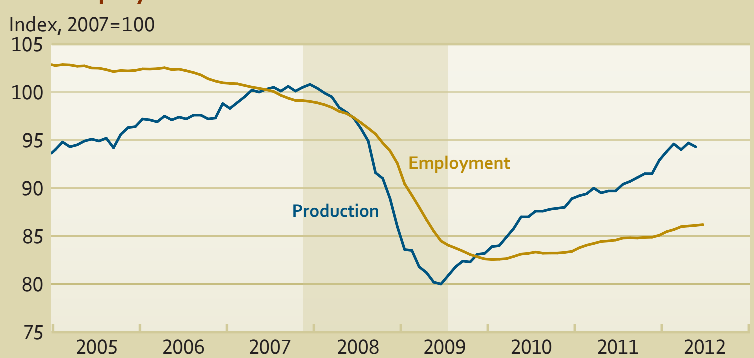
Simply put, manufacturing companies today can do more with less. And they have. Manufacturing employment has fallen 1.5 percent per year since 1980, according to the BLS. At the same time, manufacturing output rose 3.1 percent per year, according to the Federal Reserve Board. In the end, increased productivity levels make it quite improbable for manufacturing to be the major employer it once was.

"When you look at the labor side, it's not a pretty story," said Bill Strauss, senior economist and economic adviser at the Federal Reserve Bank of Chicago. "We still need millions of workers in manufacturing, but in terms of growing that workforce, most of the output has increased based on productivity."

2 Why won't manufacturing comprise as much of a share of GDP as it once did?

Manufacturing's share of GDP has declined over the years partly by virtue of the industry's own success. Increased productivity has allowed manufacturers to lower unit-labor costs, leading to lower relative prices for manufactured goods. Put another way, prices of manufactured goods have not increased as fast as other prices have. Holding the changing price level constant, manufacturing output has grown, on average, 1.7 percent per year since 1960 while total output has grown, on average, 3.1 percent per year. Thus, as a matter of accounting, manufacturing has made up a smaller share of GDP over time.

Still Recovering: Manufacturing Productivity and Employment Since the Recession



Sources: Federal Reserve Board; Bureau of Labor Statistics.

The recent recession and recovery have only accelerated this trend of doing more with less. The recession saw manufacturing employment and production fall roughly 17 and 20 percent, respectively. Production levels have regained nearly 15 percent of lost production, but employment levels have recovered only about 3.5 percent. This translates into stronger productivity gains, averaging 4.6 percent over the past two years, than posted during the 1990s or 2000s. Amazingly, manufacturing employment levels have now fallen to levels not seen since 1941, even as production levels have returned to 2005 levels.

3 Can we sustain these productivity increases?

Increasing productivity depends on new technology and a skilled workforce. Here lies one potential problem for the future of manufacturing in America: With almost 50 percent of production workers over the age of 45, according to the Census (Integrated Public Use Microdata Series, or IPUMS), the manufacturing workforce is quickly "graying." Older workers will need to be replaced over the next decade, and there may not be enough younger workers with the necessary skills to do that.

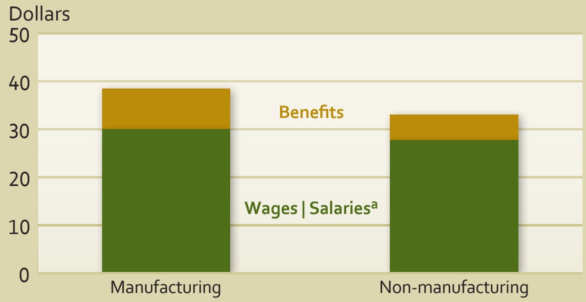
Perhaps what manufacturing needs here is a marketing makeover. To ensure we have enough younger workers in the pipeline, we might need to change perceptions about careers in manufacturing. Today's manufacturing environment is a far cry from the caricature industrial revolution-type factory job. It is a highly automated environment that requires specific technical skills above and beyond a strong back.

If anything can help change the perception about a career in manufacturing, it is the pay and benefits manufacturing workers receive. On average, compensation packages are 17 percent higher in the manufacturing industry compared with nonmanufacturing jobs. Manufacturing wages and salaries average $29.75 per hour compared with $27.47 for nonmanufacturing jobs, while benefits average $8.52 for a manufacturing job versus $5.37 for a nonmanufacturing job. And three out of four manufacturing workers have both retirement and medical care benefits, compared with only 55 percent of their private service-providing counterparts, according to the BLS. In total, the average compensation package for a manufacturing job is $38.27 per hour while a nonmanufacturing job averages $32.84 per hour.

The compensation premium partly reflects the skills and training of the underlying workforce. So if young people can be persuaded that manufacturing has a future, the next step is to adequately train future workforces. We have our work cut out for us on that front. The United States ranks 29th in math and 21st in science out of 65 countries, according to an Organization for Economic Co-operation and Development (OECD) survey.

Another way to address a possible worker shortage is to retrain the existing workforce. In 2010, 36 percent of unemployed production workers were between the ages of 16 and 34 (IPUMS). One policy approach to "upskill" this group would be to support the network of community colleges across the country, especially those that work with local employers to design curricula around the needs of the workplace. Collaborative efforts like these are a good way to ensure the skills of the workforce better align with the needs of the workplace.

Employee Compensation per Hour by Major Industry, 2010



a. Wages | Salaries include paid leave and supplemental pay.
Source: Bureau of Economic Analysis.

"Manufacturers are telling us that they're having trouble finding the workers they need to be able to succeed," said Chad Moutray, chief economist with the National Association of Manufacturers. "We need to continue to invest in education and change perceptions about the value of manufacturing to make sure that manufacturers have the workers who can work in those facilities."

4 What strengths should the U.S. build on?

The United States still remains the world's top manufacturer, reports the OECD, accounting for 19 percent of the globe's manufacturing total value added. Moreover, real manufacturing exports increased 43 percent from 2002 to 2011 compared to a 15 percent increase for real GDP over the same time period, according to the Census Bureau and BEA. Most of this increase is accounted for by America's comparative advantage in highly technical industries like aerospace, medical and pharmaceutical development, and computer and electronic components production.

To remain the leader, the United States must take advantage of its strengths. Patent laws make the United States a premier destination for research and development dollars and, in fact, the nation leads the world in patents per year (OECD). More important, an increasing proportion of R&D dollars are being spent by private companies, according to the National Science Foundation, which are much more flexible and better able to respond to market needs than publicly funded research dollars. Policies designed to motivate research allow manufacturers to create innovative products as well as pursue technologies that will lower costs.

An increasing proportion of R&D dollars are being spent by private companies… which are more flexible and better able to respond to market needs than publicly funded research dollars.

"The one big advantage we have in the United States that other countries don't have is a very innovative economy," said Daniel Meckstroth, chief economist with the Manufacturers Alliance for Productivity and Innovation. "We have a very good infrastructure, we have the best universities in the world, and we are able to have high income because we are very productive and have high value-added per worker. You get that through becoming innovative, being technologically advanced, and applying capital to workers to increase productivity."

Another strength is energy. The United States has a relatively dependable energy infrastructure network, subject to few service interruptions and thus providing for better management of production runs. The United States also has access to energy-related natural resources. Low natural gas prices allow not only for lower electricity costs, but also for cheaper feedstocks that go into industrial chemicals. Moreover, new innovations in exploration and production techniques associated with shale gas reserves are projected to provide a dramatic increase in both petroleum and gas reserves. Thus, energy costs should remain low for the next decade. Policies designed to promote a reliable energy infrastructure and the development of new energy sources will provide added incentive for manufacturers to locate in the United States.

Down but not out

Despite major changes, manufacturing does still matter in the United States, even if it no longer provides the employment base or comprises the share of GDP it once did. As long as policies can be implemented to address potential problems while capitalizing on our comparative advantages, the U.S. manufacturing industry can remain a global leader. ■

Watch short interviews with conference participants
www.clevelandfed.org/Forefront/2012/summer/ff_2012_summer_13.cfm

Resources
For the complete set of conference presentations, visit
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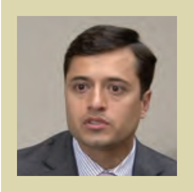
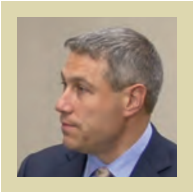
Housing and the Economic Recovery

Todd Clark
Vice President and Economist



Amir Sufi

Professor of Finance at the Booth School of Business, University of Chicago



Chris Mayer

Paul Milstein Professor of Real Estate and Finance and Economics at Columbia Business School, Columbia University

Problems in the housing sector have proven to be one of the most stubborn obstacles to a full economic recovery. Is the housing market finally turning a corner, and what policies might help it do so more effectively? The Federal Reserve Bank of Cleveland invited two housing experts, Amir Sufi and Chris Mayer, to talk with Bank economists and officials about their research. During a break in the presentations, Todd Clark, vice president in charge of the money, financial markets, and monetary policy group, sat down for this interview with these academics.

Clark: ***Can you talk a bit about where we stand with the housing sector today? Are we any better off now than we were a year ago? Amir, let's start with you.***

Amir Sufi: I think we are better off now than we were a year ago. We've seen some recovery in house prices—mainly a leveling off. We've also for the first time actually seen, in the last few quarters, a positive contribution from residential investment to GDP, which is a good sign that we're seeing some building.

But unfortunately, we still have, in my view, a long way to go before we're at what would be considered healthy or normal levels of building and house prices to be at levels that are sustainable with long-term growth in the housing sector. So I think the news is very cautiously optimistic; we're not in freefall anymore, but we still have a long way to go.

Chris Mayer: I agree with Amir's assessment. I think we have hit a bottom; much of it's because we have a lot of cash buyers—investors—coming into the market who are willing to rent out houses, so roughly 30 percent of houses are going to people who are not going to live in them. But that still has helped put a bottom on house price decline.

But there's a very uneven recovery. The place that we haven't seen much improvement has really been on the credit side, which is the ability of new homebuyers to borrow. It would seem credit is, if anything, tighter today than it was a year ago.

Clark: ***To what extent do you think the problems in the housing sector have been holding back the pace of recovery, and to what extent do we need to address those problems to get a faster pace of recovery in the overall economy?***

Sufi: I have a strong view on that. I think that housing ends up being very important for the recovery precisely because households have a lot of debt associated with those houses. Mortgage debt and home equity debt were at historic highs when the housing market collapsed and that continues to be something that's, in my view, holding back the recovery.

When households have extremely high debt burdens, they have a more difficult time accessing credit. They also may feel poorer just in terms of where they need to be in their net wealth position. And so a very natural reaction, something we found very strongly in our research, is that people pull back on their spending behavior when they find themselves over-burdened with debt associated with their home.

So either you have to have a robust recovery in house prices, or you would have to have some kinds of proposals to allow borrowers to access credit more easily. Or, perhaps more dramatically, you do something to help try to write down the debt burdens that households have. And if you were able to do one of those three things, I think you would see a much more powerful recovery. But in the absence of one of those three things—either a house price recovery, helping people refinance into lower rates, or writing down debt burdens—my view is that the recovery is going to be quite weak. We'll see economic growth, but not the kind of economic growth we would want to generate significant job growth.

People pull back on their spending behavior when they find themselves over-burdened with debt associated with their home"

Mayer: I'm probably only slightly more optimistic. Just to put some other numbers to it, in a typical recovery we'd be building 2 to 2¼ million houses. We've been building at about 500,000; that's probably 2 to 3 percent of GDP. Two to 3 percent of GDP is the difference between anemic growth (which doesn't create many jobs) and a much more robust recovery.

The optimistic piece of this is that we continue to add 800,000-plus households a year. We have 3 million people who haven't formed households and at some point are going to start forming households. So I think we are going to see demand grow a little bit—just demographics, not for any other reason—and that is going to lead to some additional construction over time, even with all of the headwinds.

Clark: ***Are there reasonably feasible policies that you think would help stimulate the pace of recovery in the housing sector over the next couple years?***

Mayer: I've been a very strong advocate of pursuing a widespread refinancing program starting with loans that are guaranteed by the government through Fannie, Freddie, and the FHA [Federal Housing Administration]. Our best estimate is that we could easily accomplish 10 million to 15 million refinancings. We should have done this a long time ago, and that would have significantly helped with the debt burdens. I think that's the biggest thing.

But the second is, we really have to work through some of the problems that we see in the system—people who are living in houses who haven't been making payments for two or three years, lenders who are still unsure of what the rules are and often misapplying the rules. We need to get these things fixed finally. I think the state attorneys general settlement will help with this, but we really need a system that borrowers and lenders can rely on, so that everyone understands what the rules are going forward. And unfortunately, I haven't seen the kind of progress on that that I'd like to see.

Sufi: If you just take a step back and look at the policy responses that the government's made: It's been woefully inadequate on the housing side. We've seen very aggressive policies in terms of fiscal stimulus and in terms of financial assistance to financial institutions. But in general we have not seen the kind of widespread, successful, "affect-a-large-number-of-borrowers" types of activities.

I also tend to think—something that may be a little more controversial—that we should at least have on the table some kind of program that would assist homeowners in modifying or restructuring their debt. So not only making interest payments lower, but also trying to attack the household debt problem directly through some type of help in restructuring mortgages. We've had some of those programs, but they've proven very difficult to implement.

Clark: ***Last question: the long run. We used to think of housing's importance in the economy as being something like 5 or 6 percent of GDP in terms of residential investment, with that being the long-run norm. Do you think we can ever hope to get—expect to get—back to that?***

Mayer: There's every reason to believe that even markets that have been really severely hammered by this crisis—for example, California—will eventually get back on the growth path. It may take five or 10 years to get there.

But more important in the long run will be productivity in the economy and labor market. If we rely on housing for growth or a recession, we're in a lot of trouble.

Sufi: I think in the long run things like household formation, productivity growth, and population growth will be the determinants of the housing market. I would add maybe one caveat: the homeownership rate in the United States was at about 63 percent for 30, 35 years, and then it jumped up closer to 70 percent in a period of about 10 years, from 1998 to about 2006.

As an economist, when I look at a statistic that's stayed level for 35 or so years and then all of a sudden jumps up very quickly, that tends to tell me that probably the long-run equilibrium is closer to what we had before—the 63 percent, 64 percent homeownership rate. ■

Watch this interview online

www.clevelandfed.org/Forefront/2012/summer/ff_2012_summer_01.cfm

Recommended reading

Learn more about this interview on housing at
www.clevelandfed.org/Forefront/2012/summer/ff_2012_summer_02.cfm

A Plausible Culprit

Maybe you've heard the view that the financial crisis is to blame for the frustratingly slow pace of the recovery. Economists Carmen Reinhart and Kenneth Rogoff have made the highest-profile case for this story. After examining eight centuries of economic cycles, they argue that recessions associated with major financial crises are likewise expected to be major. By extension, the associated recoveries are likely to be less than spectacular too, the authors claim. It seems the economy has a tough time achieving liftoff if the financial markets—which provide crucial services for borrowers and lenders—have suffered a meltdown.

That's perhaps true of the global historical record, as Reinhart and Rogoff recount. But do financial crises adequately explain the U.S. experience? Economists Michael Bordo of Rutgers University and Joseph Haubrich of the Cleveland Fed recently set out to address that question. What they find, in sum, is that there may be a more plausible culprit for the sluggish recovery than the financial crisis—the housing market.

Haubrich and Bordo looked at 27 U.S. business cycles since 1882.* Unlike Reinhart-Rogoff, Haubrich and Bordo conclude that financial crises often breed quite strong recoveries in the United States. In fact, they find that a 1 percent deeper financial-crisis recession leads to an extra 1.5 percent of growth in the quarters following the cycle's trough.

More important than the role of financial markets appears to be the role of the housing sector, say Haubrich and Bordo. They note that residential investment by itself may not make up a large part of national spending, but it is linked to many other consumer durable purchases and housing-sensitive sectors, making its impact much larger than it might first seem.

The authors aren't certain whether housing is directly to blame for the weak recovery, or merely associated with it. Nonetheless, they determine, "the role of housing does stand out as a marker for weakness in the current recovery."

This doesn't necessarily mean that housing must recover for the broader economy to follow suit. Haubrich and Bordo say that's a question for another day. But their analysis does suggest that people might not want to take for granted the claim that our current woes are mainly the fault of the financial crisis. The distinction is important as policymakers prioritize their efforts to prevent or cushion the blow of the next, inevitable recession. ■

—Doug Campbell, Editor

Resources

Find Michael Bordo and Joseph Haubrich's paper, "Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record," at ***www.clevelandfed.org/research/workpaper/2012/wp1214.pdf***

* The authors used some of the same modeling techniques as in their 2010 paper that found that contractions associated with financial crises tended to be more severe, but the paper did not examine the implications for recoveries.

How Big Is the Too-Big-to-Fail Subsidy?

Forefront talks to the Cleveland Fed's James Thomson, vice president and financial economist.

Forefront: ***Critics of too-big-to-fail financial institutions often argue that the government is essentially giving those institutions a subsidy. If true, can this implicit subsidy be considered an expenditure of taxpayer dollars, money that could be used for something else?***

Thomson: If the government is giving someone something of value, this is the same thing as an expenditure. In the case of too-big-to-fail (TBTF), the government is providing an option to the stakeholders of TBTF firms to assist them in times of trouble, and doing so free of charge. Private entities (such as insurance companies and hedge funds) would charge a fair value for such options. By not doing so, the government is forgoing revenues that could be used for other purposes. So yes, the implicit subsidy (or any subsidy) is equivalent to a tax expenditure—like investment tax credits, fair housing credits, and so on.

Forefront: ***Of course, size is only one consideration with systemically important institutions. You've written in the past about other features—contagion, correlation, complexity, and concentration. Is shrinking these institutions the overarching goal of a policy that would make them cover their implicit subsidy?***

Thomson: Yes, the point of my 2009 policy discussion paper on these features is that size alone does not determine whether a financial company is systemic (or TBTF)—it's much more complex than that. Charging financial companies a fee that equates to the fair value of the TBTF subsidy should result in smaller and less risky firms. Moreover, charging TBTF firms the cost of the subsidy would internalize the costs of externalities (the spillover effects) associated with their decisions. This should produce less risky financial companies and reduce their systemic impact.

Forefront: ***If you're a depositor at one of these TBTF banks, you are protected from losses. So why does that matter if we're talking about insured institutions? Or, in economic terms, through which channels is the TBTF subsidy showing up?***

Thomson: There is an extensive literature on federal deposit guarantees and the subsidy associated with them. When we discuss the problem of TBTF, the problem becomes one of subsidies associated with implicit and explicit deposit guarantees. The subsidy associated with explicit deposit guarantees is not specific to the size of an institution—it's simply the difference between their value and the deposit insurance premium. The implicit deposit insurance subsidy is essentially the TBTF subsidy. This occurs when financial system supervisors don't close a bank that is insolvent and impose losses on uninsured depositors and other creditors. It can also happen when supervisors handle the bank failure in a way that extends protection to all liabilities. TBTF institutions boost the value of these subsidies by increasing the risk they incur in the course of seeking returns on their investments.

Forefront: ***OK, so how big is the subsidy? Can you put a number to it?***

Thomson: We don't have a number that economists would agree on. But some academics are actively working on measuring the subsidy. Three economists at New York University [Professors Viral Acharya, Robert Engle, and Matthew Richardson] are working on measuring the subsidy by trying to calculate the costs that systemically important companies impose on the financial system. This is one of the more promising approaches, and one way to get at the subsidy.

Ed Kane [Boston College] and some of his coauthors are trying to measure the TBTF subsidy using an option-pricing approach. They are trying to measure the subsidy by valuing the taxpayer "put"—the value associated with being able to put the losses onto taxpayers. In a sense, the same kind of work is underway at various regulatory agencies, at central banks, and at the Bank for International Settlements in the design and calibration of the Basel III international capital standards. There is a capital surcharge for systemic risk—an indirect way of pricing it. Calibrating the capital surcharge implicitly requires measuring the TBTF subsidy.

Also, conceptually, the stock market value of a systemic financial company should price the stream of TBTF subsidies—something Ed Kane would call "government-contributed capital." So we would need a model that could separate out the government-contributed capital from the franchise value of the firm.

Forefront: ***Economists don't agree, but is there a ballpark figure?***

Thomson: Using some numbers on the annual systemic risk premium, you can get a number in excess of $45 billion. If you assume that the value of the TBTF subsidy is the capitalized value of the annual systemic risk premium, then you get numbers between $450 billion and $900 billion. But these are just back-of-the-envelope estimates.

Forefront: ***And I take it that getting a more precise number is important because that's the amount regulators can then properly price as the capital surcharge. This might provide the government's budget some protection. On the other hand, have you or others thought about what might happen to these institutions if we were able to start charging them accurately to offset their subsidy?***

Thomson: If institutions were to be charged a premium for the full value of their estimated implicit TBTF guarantee, then I suspect they would respond by shrinking and becoming less complex to some extent (at least the very largest and most complex). How much is the question.

Forefront: ***If institutions do respond in these ways, would you say that the main reason these institutions grew to such large size and complexity in the first place was to capture the benefits of the subsidy?***

Thomson: Well, it would be consistent with that reason, but you could also say that the existence of the implicit subsidy enabled these companies to become larger and more complex than otherwise would have been the case.

Forefront: ***Is it fair to say that even if we can put a number on the implicit subsidy, the ultimate costs imposed on the rest of us are a lot larger?***

Thomson: In a recent paper, a couple of Federal Deposit Insurance Corporation economists claim to have measured the TBTF subsidy. They find it is on the order of 20 basis points in terms of lower funding costs. But yes, there are externalities associated with the TBTF subsidy that impose costs on the rest of us. So TBTF institutions respond to the subsidy by increasing their risk though either engaging in riskier activities or increasing their leverage. While these actions may be privately optimal, the response to the TBTF subsidy is not socially optimal, as it can pose huge risks to the financial system. That's why the ultimate social costs of the subsidy are much larger than the 20-basis-point private benefit that some have found. ■

Recommended reading

For more on TBTF and the subsidy from the economists mentioned in this article, visit

www.clevelandfed.org/Forefront/2012/summer/ff_2012_summer_03.cfm

and click on the embedded links

Interview with Alex Kotlowitz

The Cleveland Fed's 2012 Policy Summit closed with a different kind of speaker than most who came before him. Though not a researcher, policymaker, or community development practitioner, Alex Kotlowitz shares a passion for understanding why some neighborhoods thrive and others founder. He has spent years living and working in inner-city neighborhoods, observing up close the unique and steep challenges facing the people who live there.

His first-person reporting made him a fitting voice to wrap up the two-day Policy Summit.

Kotlowitz is a writer whose 1991 book *There Are No Children Here* followed two years of the struggles of two young brothers living in a Chicago housing project. The book won several awards, sold half-a-million copies, and landed on the New York Public Library's list of the 150 most important books of the century. More recently, Kotlowitz co-produced the 2011 documentary film *The Interrupters*, which relates the story of three violence "interrupters" working for an innovative anti-violence organization in Chicago.

Between these and other projects, Kotlowitz's "day job" is writer-in-residence at Northwestern University. He teaches courses every winter and also serves as a visiting professor at the University of Notre Dame. *Forefront* editor Doug Campbell interviewed Kotlowitz following his formal remarks on June 29, 2012. An edited and condensed transcript follows.

Forefront: ***Today you were in a room full of economists and other people very comfortable with numbers, and you were telling stories that were very powerful, sometimes heartbreaking. What value do you think that brings to academics?***

Kotlowitz: What economists do and what policymakers do is incredibly important. They step back and try to look at the broad picture and try to figure out what policy makes sense, what policy works, what policy doesn't work. What I hoped to do today was simply remind them that we're talking about real people, and that people are complicated. They're messy. I know that economists think about people making rational choices.

One of the questions that came up in my dinner with a group of economists last night was, why does it seem that people living in very impoverished communities don't make the rational choice? The challenge is to understand why, for them, it might seem rational in the moment. Not that it justifies it, but to understand it, to try to understand who they are. I guess I hoped to give what they do some humanity.

Forefront: ***You talked about the state of our inner cities and how a man from Englewood on the southwest side of Chicago recently remarked how things have gotten so bad. Do you really think things have gotten worse in our inner cities in the past 25 years?***

Kotlowitz: There are a lot of things that have changed over the past 25 years, and some for the good. I think the church, especially the black church, has become much more engaged in these communities. There's been the growth of community development corporations. The CDCs have grown, and in some cases performed minor miracles, but funding is incredibly short.

There was an effort in places like Chicago and other cities to tear down public housing, to raze these monolithic, monstrous structures that probably never should have been built in the first place. So there are things to make us think that we are doing better. And there are probably some good things to say about welfare reform.

But it's troubling to me that when you go into these communities, especially in the wake of the 2008 economic collapse, you see communities that physically look in some ways worse than they did 15 or 20 years ago. In the course of filming [*The Interrupters*]—we filmed from the summer of 2009 to the summer of 2010—we literally saw blocks change during the course of that year because of the foreclosures. Then you've got the stubborn persistence of the violence. You've got the schools, which we are still struggling with. We've been very good in our cities in creating these terrific magnet schools, but schools in these communities are still not functioning. The dropout rate is still extraordinarily high. So in some ways things have not gotten better, and in other ways they've gotten worse.

Forefront: ***If you're consuming just the top level of news, you may have heard that crime has gone down, and technology has spread to many places. How is it possible that we're still struggling with the same problems?***

Kotlowitz: I don't think that we as a nation, our body-politic, really wants to contend with these issues. These communities are where they're at in many ways because they've been neglected, and they're still neglected.

Alex Kotlowitz

Positions

Freelance writer and producer

Writer-in-residence, Northwestern University

Books

There Are No Children Here: The Story of Two Boys Growing Up in the Other America, 1991, Anchor

The Other Side of the River: A Story of Two Towns, a Death and America's Dilemma, 1999, Anchor

Never a City So Real, 2004, Crown

Selected Articles and Projects

The Interrupters, 2011, documentary about anti-gang-violence program in Chicago

"Blocking the Transmission of Violence," *The New York Times Magazine*, May 4, 2008

"The Unprotected," *The New Yorker*, Feb. 8, 1999

Awards and Honors

George Foster Peabody Award, the Robert F. Kennedy Journalism Award, and the George Polk Award; recipient of three honorary degrees and the John LaFarge Memorial Award for Interracial Justice given by New York's Catholic Interracial Council

I don't think that's changed. But you point to something that for me is the Great American Paradox—we're in a country that likes to think we're all in this together, and yet we're still so incredibly disconnected from each other.

My first book, *There Are No Children Here*, came out in 1991, and I remember when it came out people said, "Oh my God, this can't be." And I felt the same way when I began reporting the book. People felt angry, they felt ashamed. With *The Interrupters*, here we are 20 years later, this film comes out, and from people I still hear the same thing—"I had no idea. I can't believe these communities are like this." And you just want to ask, where has everybody been?

Forefront: ***You made a useful distinction between the "poverty of the pocketbook," which I think we all understand, and the "poverty of the spirit." What do you mean by that and why do you think we're suffering from it?***

Kotlowitz: This is not something new. Poverty of the spirit has to do with lack of aspiration, lack of hope, the sense that "this is my life." And that's one of the things that is clear to me has not changed. That window of opportunity has not gotten any larger. In some cases it has gotten smaller, especially, again, in the wake of the economic collapse in 2008. What you see are people who are dispirited, who maybe haven't given up but who maybe have become resigned to the idea that this is my life, this is going to be the life of my children. Or who throw their hands up because they don't know what the answers are, how we find our way out of this.

Forefront: ***You discussed the need for policy solutions to be holistic, and that's a theme of this Policy Summit. But an interesting contrast is your look at the group Ceasefire in* The Interrupters*. That was a very targeted approach asking "What's the problem?" It's too much shooting. Then, "How do you stop it?" You stop the shooting.***

Kotlowitz: You're absolutely right; this group, Ceasefire, targets just the violence. They want to get in there and mediate the disputes. But it became clear to us as we were filming that as you look at all the other forces bearing down on people, how can you not wrangle with those? And there's actually a moment toward the end of the film when one of the characters begins to wonder aloud whether in fact what he's doing isn't just a band-aid. Because people come to him and they want jobs, they want housing, they want all the things that we know are so woefully lacking in these communities.

I've had conversations with the people at Ceasefire about this very thing. If you're a public health organization, one of the things you've also got to do is change conditions. You're right, that's how Ceasefire does things; they're very narrowly focused, and I would argue maybe too narrowly focused.

Forefront: ***Or maybe they're a prong in a multipronged approach.***

Kotlowitz: That would be the other way to think about it, that what they do is very narrow and very important, which it is. But they need to acknowledge and understand that it's also incredibly critical that we find a way to provide meaningful work in these communities, that we need to provide better schools, that we need to provide affordable housing—all the things we know that make up strong communities.

Forefront: ***In your work and in your journalism, what's the next thing for you?***

Kotlowitz: For me, in the end, I'm a storyteller, so I'm just always looking for good stories. And sometimes I find my way back into these communities that I've been writing about for the past 25 years. There are also other issues that I feel are really pressing, not the least of which is immigration. But I intend to keep writing, and I intend to keep writing about people who are kind of outsiders. ■

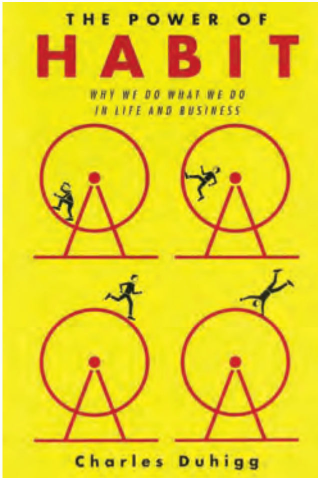
Watch video clips from this session and Kotlowitz's keynote address at

www.clevelandfed.org/Forefront/2012/summer/ff_2012_summer_10.cfm

Related link

See *The Interrupters* in full at ***www.pbs.org/wgbh/pages/frontline/interrupters***

Book Review



The Power of Habit: Why We Do What We Do in Life and Business

by Charles Duhigg
Random House, 2012

Reviewed by
Robin Ratliff
Executive Editor

In just its first month of operation, the new Horseshoe Casino in downtown Cleveland welcomed about half a million people through its doors to hit the slot machines, sit at the World Series of Poker table, and take their chances at the various gaming tables. Guests have come from near and far, including foreign countries.

Why do games of chance draw such widespread enthusiasm and generate multiple return visits? In these times, it's probably not the vast sums of discretionary money lining people's pockets. In some significant measure, it must be the rush that comes from a craving to win.

New York Times journalist Charles Duhigg, in his smashingly popular new book, *The Power of Habit: Why We Do What We Do in Life and Business*, gives us the science behind the behavior. Not only does he explain the neurology behind individual free will, he also outlines the powerful behavior patterns that influence social movements, marketing campaigns, and business results.

Duhigg frames the psychology behind the individual habit loop in a simple three-part process. It starts with a cue (location, time of day, routines, emotional triggers) that quickly cycles into a routine (the behavior itself, whether physical, mental, or emotional) and ends with the ultimate reward (the bedrock satisfaction that drives the habit loop). He contends that if you discover the structure behind the cue, routine, and reward cycle, you can change the habit.

Most of us want to understand why we engage in what seem like mindless actions, especially those that are harmful to our health, relationships, and daily living. Not surprisingly, it turns out that those seemingly mindless behaviors are controlled by a primitive structure deep within the brain known as the basal ganglia. This sector stores knowledge of activities that have become habitual—such as putting on our shoes or backing out of a driveway. Complex thinking, on the other hand, occurs in the outside layers of the brain in the prefrontal cortex. The ability to do several tasks at once owes to the basal ganglia's taking charge and making our routine tasks effortless. That's a good thing for the most part.

But the brain's dependence on automatic routines can also be dangerous, because habits can be as much a curse as a blessing. Duhigg tells a harrowing tale of a compulsive gambler who continues to be lured back to the casinos and ultimately loses her home and blows her inheritance because she feels powerless to overcome the urge to win.

A cognitive neuroscientist has determined that pathological gamblers actually see near-misses on a slot machine as wins—triggering behavior that keeps them gambling when they should logically walk away. Duhigg reports that gaming companies, understanding this psychology, have been reprogramming their slot machines over the past few decades to supply a more constant stream of near-misses to keep people coming back.

Then there are the implications of habits for retail marketing plans. Target uses data from customer loyalty cards and redeemed coupons to create complex individualized demographic profiles. These profiles show when parents are gearing up for summer camp season or when expectant mothers are likely to deliver—all based on their purchasing histories. The store can then use that information to push out more promotions to keep people coming back to shop for more.

Duhigg offers an array of examples on how habits lead to outcomes, for both good and ill. For me, the most compelling of his stories focus on transformational change within organizations. For example, NFL coach Tony Dungy used the power of habit to turn around the foundering Tampa Bay Buccaneers starting in the late 1990s. Instead of using a thick playbook, he coached his players to use only a handful of formations, concentrating on where their opponents were lining up and moving on the field. He shifted the team's precise behavior patterns until their performances became automatic and they began to believe they could win. In just a few years, the Bucs were division champs and within a decade, won the Super Bowl.

Then there is the amazing power of "keystone habits"—which identify a few key priorities in an organization and fashion them into powerful levers for change. Former Treasury Secretary Paul O'Neill accomplished this at Alcoa when he was named CEO. By putting a laser focus on the keystone habit of worker safety, with a goal of zero injuries within the company, he set a standard for excellence that every employee could salute and support. The strategy worked—with Alcoa's annual income increasing by a factor of five during his tenure as leader.

Pathological gamblers actually see near-misses on a slot machine as wins—triggering behavior that keeps them gambling when they should logically walk away.

Without keystone habits, very bad things can happen. In the late 1980s in a London subway station, 31 people perished because no single person, department, or engineering chief had ultimate responsibility for passenger safety. Operating within their "boxes" of functional routines and failing to escalate the emergency to the right authorities, employees allowed a small fire to rage into a death trap.

Although Duhigg does not offer a specific example related to the economics profession, he does provide some food for thought. Traditional economists tend to describe people as rational beings who are unlikely to make repeated mistakes. Behavioral economists have made inroads by trying to account for imperfect rationality, but it's safe to say that mainstream economics continues to rely on "homo economicus"—the rational man—who, as Duhigg's work makes clear, is more an archetype than a reality.

The Power of Habit offers so many forceful stories and underlying psychologies behind them that it's hard to stop thinking about the possibilities for old patterns to be rethought and bad habits transformed.

What if all members of Congress committed to a keystone habit of fixing the U.S. fiscal cliff before disaster hit? What if a retail data mining strategy focused on giving consumers the option to choose sustainable products to reduce materials going to landfill rather than adding new plastic gadgets to our homes? What if all of us took a good, hard look at the mindless routines we follow in our own lives and resolved to change a couple of them to make life better for our families and co-workers? Not so crazy a habit to get into, come to think about it. ■

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