
In Review

Lure of the Big City

REVIEWED BY IKE BRANNON

Triumph of the City: How Our Greatest Invention Makes Us Richer, Smarter, Greener, Healthier, and Happier,

by Edward Glaeser

352 pages; Penguin Press, 2011

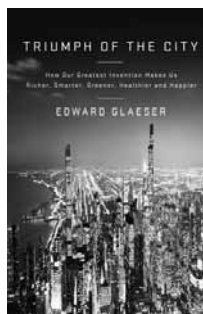
I grew up referring to Peoria, Ill., as the “Big City” in a non-ironic way. My friends and I in our small town a few miles to the north found Peoria vast, intimidating, and even a bit exotic. When I went off to college I told people that I was, in fact, from Peoria rather than my real hometown so that no one would think I was a hick. Shockingly, this dissuaded no one.

Growing up in a small town can inculcate chauvinism against big cities, which we took as a matter of faith to be dangerous, inconvenient, and impersonal, lacking entirely the sense of community fostered in small towns. That opinion is not uncommon among small-town folk.

Of course, denizens of big cities recognize the folly of such an attitude, and I had to live in one myself before I could see the errors of my ways. But not everyone from the greater Peoria area or any other small community will be able to experience life in a big city. Part of Ed Glaeser’s task in his new book *Triumph of the City* is to convince these people of the inherent advantages of big city living, and that big city life can be consonant with the values we typically associate with small towns.

The tale of fish-out-of-water conservatives adapting and thriving in a big city has been told before; witness Rod Dreher’s paean to granola conservatism a few years ago (“Birkenstock Burkeans,” *National*

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Review Online, July 12, 2002) that drew widespread enmity from the *National Review* crowd. The derision heaped onto this idea was partly self-afflicted — his implicit assumption that conservatives viewed eating vegetables as radical was taken as a bit condescending by a few of his conservative city brethren and as an insult to small-town living. But the broader point — that conservatives can thrive outside of the small town and suburbia — was valid.

Human capital | Glaeser’s defense of the city is more substantive than that. He focuses on the more tangible rewards to big city life, such as community, health, jobs, and the cities’ disproportionate impact on the economy. As I discovered upon moving to a big city myself, it can be much more difficult living in isolation there than in a smaller town, where the need to travel everywhere by car can minimize encounters with friends and acquaintances. The forced sociability can be a real curse at times, but usually it is a source of comfort for most and one that scientists believe leads to greater happiness and better health. The near-impossibility of living the city life without copious walking is another ancillary health benefit, as well as the peer pressure that comes from being surrounded by the skinny fitness fanatics who eschew fatty foods and who tend to congregate in big cities. (Another benefit of city life is the vast quantities of beautiful people that seem to inhabit it, if you’re into that kind of thing.)

It is this forced sociability that gives cities a marked advantage when it comes to the economy as well, at least in non-dysfunctional cities. Changing jobs in a small town can be difficult since there are usually only a few employers. Making a switch can entail a faraway commute to another town, settling for a job that is a much worse fit, or leaving the community altogether. Of course, the latter is much easier said than done: most jobs are filled by word of mouth, via friends or acquaintances who pass along news of openings via an informal network.

This truism means that life in the big city makes changing jobs much easier to do than in a small town. (I should know, having had six different jobs in the past four years.) The mobility makes it easier for a worker to find a job that is a better fit; it also makes it much easier for an employer to find qualified and motivated workers. The result is that new businesses and capable workers flock to urban environments.

Ultimately, it is the human capital, more than anything else, that gives the edge to big cities as a way of organizing society. Cities that chase away human capital either explicitly (like Coleman Young did in Detroit in the 1970s, a story Glaeser recounts in some detail) or implicitly (via high taxes and poor services) suffer accordingly. The way to recover is by redoubling efforts to change the climate to make the city more attractive to the young, talented, and educated. This is a persuasive argument and Glaeser delivers it without veering too closely to the Richard Florida school of pop-culthood. Boston survived the demise of its industrial base decades ago because of its human capital: Detroit’s economy cratered with the diminution of the auto industry because of its lack of human capital.

Glaeser points out that liberal responses to big city woes that ignore this are doomed to failure. Cities that impose their own income tax almost invariably

chase people and businesses out of town and raise much less money than first anticipated. Most of the high cost of real estate in New York City is due to restrictive land use regulations and not the scarcity of land (a policy error shared by Mumbai, incidentally). Investments in big, vaguely utopian projects (such as the Detroit People Mover downtown rail system) invariably fail to do anything for the economy.

City conservative | While people praising the virtues of urban life do not typically fall under the conservative label, Glaeser's message on the virtues of cities and how they can be improved is fundamentally

a conservative — and worthwhile — one: Cities need to focus first and foremost on making livable communities, and the people, jobs, and economic growth will follow. While he is at it, Glaeser reminds us in a plethora of ways that subsidizing businesses to relocate to the city or remain there, embarking on grandiose projects, or paying munificent salaries for government workers are ultimately counterproductive.

Improving schools, reducing crime, and making real estate less expensive is the formula for a prosperous city — and one that might actually attract a few conservatives as well. R

Surveying these cases, it becomes evident that private action can suffer from the same incentive defects that we find in political and bureaucratic action. The decision makers in philanthropies — the presidents and program officers — do not have a reliable feedback mechanism to tell them when their projects are doing more harm than good. And even if they might suspect that their operations are not working as planned, they suffer no direct loss. It is someone else's money, after all.

As Milton Friedman famously remarked, "No one spends other people's money as carefully as he spends his own." Foundation officers spend fortunes amassed by others, and often do so in ways that run contrary to the philosophy of the benefactor. Rockefeller Foundation officers had nothing to do with John D. Rockefeller's great business success and felt free to lavish the foundation's money on social engineering that Rockefeller himself thought harmful. When Rockefeller found that his wealth was being devoted to purposes of which he disapproved, he also discovered that there was nothing he could do about it. Because of the irrevocability of money transfers, even to a foundation bearing one's name, we now sometimes see foundations established with fixed lifetimes — the Olin Foundation being a prime illustration.

Flexner's health care | Before getting into the particulars of Wooster's cases, it is worth noting that the private action undertaken by charitable foundations sometimes entails advocacy for new or expanded government programs. Little wonder that philanthropic programs fail when they are just backdoor routes to increased governmental intervention in society.

That point is particularly important in the first case in the book, Abraham Flexner's crusade to change medical education. Flexner was the prototype of the kind of social activist, with a head full of grand ideas, who then goes hunting for powerful supporters.

Owing to his wife's success as a playwright, Flexner was independently wealthy and wanted something to do. In 1908, he published a critical review

Paved with Good Intentions

REVIEWED BY GEORGE C. LEEF

Great Philanthropic Mistakes,

2nd edition

by Martin Morse Wooster

232 pages; Hudson Institute, 2010

Governmental mistakes that waste resources and make conditions worse are a well known, much analyzed phenomenon. Thanks to politicians, we have had to endure everything from a subsidized teapot museum in North Carolina to wars in remote regions of the world, from money-losing mass transit projects to the gigantic Ponzi scheme called Social Security.

Public Choice scholars have explained in detail why waste and folly are the norm for governmental action. To put their explanation in a nutshell, the incentives and information needed for efficiency are missing.

The extremely sorry record of governmental action sometimes leads people to think that non-governmental action must necessarily be better. That does not



follow, though, as historian Martin Morse Wooster demonstrates in the new release of his book *Great Philanthropic Mistakes*, a revised and expanded edition of a book first published in 2006.

Wooster has written extensively on the problems of philanthropy — those who are interested in the field will also want to read his 1999 book *The Great Philanthropists and the Problem of Donor Intent*. Here he investigates eight instances in which foundations squandered large amounts of wealth on visionary projects. The eight cases involve efforts at improving medical education, finding a cure for cancer, population control, creating public television, reviving the inner cities, salvaging public education (twice), and the funding of "geniuses." The cast of characters includes some of America's most prominent philanthropic organizations: the Ford Foundation, Rockefeller Foundation, MacArthur Foundation, and others.

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of higher education pedagogy, entitled *The American College*, and sent a copy to the president of the Carnegie Foundation, Henry Pritchett. Pritchett was much taken with Flexner and, when they met, offered him a job: to study and write a book about medical education. Flexner was not a medical doctor, but he undertook the work with relish. He became convinced that most American medical schools were deficient and should either be closed or reformed to what he thought were proper standards.

The resulting book proved to be a remarkable sensation, its attack on most medical schools resounding with the public much as had Upton Sinclair's attack on the meat packing industry a few years earlier. Flexner's writing was imbued with the spirit of the Progressive Era, favoring central planning by experts rather than marketplace competition and discovery. By his calculation, the United States needed only 31 medical schools, which meant that more than 100 existing schools should be shut down. He also insisted that students should already have undergraduate degrees before beginning medical studies and that professors should do nothing but teach — no outside income from practice.

The Carnegie Foundation could do nothing to implement Flexner's proposed reforms, but state legislatures could. The book dovetailed with efforts by the American Medical Association to make medical education "more professional," i.e., more of a barrier to entry. The result was increased regulation of medical education and licensing. Costs went up and many of the marginal schools folded.

Why was all this a "mistake"? The number of physicians fell from 154 per 100,000 Americans in 1910 to 121 per 100,000 by 1930. Many of the schools that were extinguished by the Flexner/Carnegie/AMA crusade had served women and racial minorities. Perhaps worst of all, the precedent was set for "expert" control over education rather than relying on competition.

There is an epilogue to the Flexner story. After his initial association with the Carnegie Foundation, he wrangled a longer one with the Rockefeller Foundation

in which he burned through millions of dollars in pursuit of his visions about the ideal medical school. Mostly, he did not get his way.

Lasker's war on cancer | Mary Lasker's husband Albert made a fortune in advertising. After his death, Mary used his money to push for a cure for cancer. Her 30-year lobbying campaign, Wooster writes, "did as much as one person can do to expand the size and scope of the federal government." She was not interested in having her foundation seek out and support promising researchers. Instead, she used the foundation's money to push politicians into making it a responsibility of the federal government to find the cure for cancer.

A good example of the Lasker Foundation at work is a full-page advertisement it placed in the *New York Times* in December 1969. "Mr. Nixon, You Can Cure Cancer," its headline read. The text went on to admonish the president to spend enough to cure cancer "by the nation's 200th birthday." It was one of the first significant pieces of advocacy to use the "If we can put a man on the moon, then we can..." conditional.

The pressure worked. In his 1971 State of the Union address, Nixon called for a \$100 million fund for cancer research, saying that the same effort that "took man to the moon should be turned towards conquering this dread disease." The Lasker Foundation succeeded in politicizing cancer research. Throwing money into the federal bureaucracy, however, is not a very good way of ensuring progress on a particular disease. Wooster quotes Dr. Norton Zinder of Rockefeller University, who observed that National Cancer Institute investigators, flush with cash, "tended to delegate study of scientific problems to friendly colleagues" and were known to award research contracts to close friends, a practice he called "embarrassing, if not illegal."

Cancer has not been cured, but large amounts of foundation money and much larger amounts of taxpayer money have been spent with little to show for it.

Ford's gray areas | This review cannot

cover all of the cases in the book, but it would be indefensible to leave out the Ford Foundation, whose one-time president, McGeorge Bundy, once cut short a discussion over a project by saying, "I may be wrong, but I am never in doubt." That attitude squandered tremendous amounts of Ford money. Consider, for example, its "gray areas" program in the 1960s.

The basic idea behind the program was to fund community organizations in impoverished areas, mostly inner cities. Ford officials assumed that activists in each community would know best what kinds of programs would be the most beneficial. Therefore, Ford first created new community organizations, giving their appointed leaders great latitude to do whatever they thought would improve conditions. The result (here Wooster quotes Harvard historian Stephan Thernstrom) was a set of organizations "so flexible as to be virtually spineless; agencies whose very existence was dependent on their ability to write proposals that reflected what their sponsors wanted to hear."

The various "gray areas" groups, primed with Ford money, went to work on improving their communities. The most noteworthy of them, named Mobilization for Youth, occupied itself by organizing the poor in New York City to advocate increases in federal welfare programs — the philanthropy-to-government pipeline again — and fomenting rent strikes. Ford was sponsoring radical political activism on the Lower East Side. This all proved to be quite an embarrassment for the foundation, which terminated its support for Mobilization for Youth in 1964, by which time the federal War on Poverty money started to flow in.

Conclusion | Wooster's book does not deny that philanthropy can accomplish worthwhile objectives. But he shows that it often dissipates wealth rather than solving problems, especially when decision makers see philanthropy as a means of catalyzing increased governmental activity. Anyone who has established a charitable foundation, or is thinking of doing so, should read both of Wooster's books. **R**

Tyler Cowen's Unpersuasive Case

REVIEWED BY DAVID R. HENDERSON

The Great Stagnation: How America Ate All the Low-Hanging Fruit of Modern History, Got Sick, and Will (Eventually) Feel Better,

by Tyler Cowen

e-book; Dutton Adult, 2011

Is the U.S. economy stagnating? The title of the new mini-book by George Mason University economist Tyler Cowen would make you think that it is.

What readers will want to know, therefore, is what Cowen means by stagnation. Unfortunately, you can scour the book, as I did, and not find a definition. If stagnation means no growth, then the U.S.

economy is not stagnating, not by a long shot, as Cowen shows. If, however, stagnation means somewhat slower growth than previously, which seems to be his meaning, then he makes a more reasonable case.

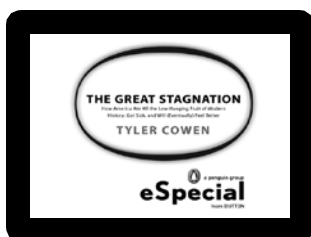
If, by the second definition above, the economy is stagnating, then why is it and what should be done about it? It is stagnating, claims Cowen, because the United States has already picked three pieces of “low-hanging fruit” that drove the economy for decades, but whose effects are now dissipating. As for what should be done about it, his main proposals are that we respect scientists more and learn to live with stagnation.

His argument about the reasons for stagnation is ultimately unpersuasive and his proposals for dealing with the problem are tepid. Moreover, he misses some major

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pieces of ripe fruit ripe that are hanging right in front of his nose.

“Stagnation” | First, consider the data he uses to make the case for stagnation. He does not give the usual measure, which is growth of real Gross Domestic Product or of real GDP per capita. Instead, he considers the growth of real median family income. The good news is that even that has grown since 1973, the year he chooses



for the break point when stagnation began setting in. The bad news is that it has grown more slowly than it did between 1945 and 1973. Interestingly, in Cowen's graph of the growth in real median

family income over time, he shows that income would have grown much faster had it kept pace with growth in real GDP per capita. He writes, “[I]f median income had continued to grow at its earlier post-war rate, the median family income today would be over \$90,000.”

This divergence between the two measures means that whatever explanation Cowen comes up with for the slower growth of median family income since 1973 should be one that is consistent with the relatively healthy growth of per-capita GDP since 1973. Do his explanations do that?

The fruit | Let us consider his three disappearing low-hanging fruit: (1) free land, (2) technological breakthroughs, and (3) smart, uneducated kids who can be educated.

Through the end of the 19th century, argues Cowen, land in the United States was cheap. Now it is relatively expensive. Yet he presents no data on this, either in the chapter or in the end notes. How big a role does the increase in the price of

land play? One way to get an idea, which I would expect an economist to use, is to look at the role of rents and imputed rents (imputed rents are rents that land owners could have earned on their land) in national income. If they are a much bigger percent of income than they were a century ago, that would support Cowen's view; if not, then not.

What do the data show? Between 1899 and 1908, according to data reported in Robert F. Martin's 1939 book *National Income in the United States, 1799-1938*, rents were about 6.4 percent of national income. Willford I. King's 1919 book *The Wealth and Income of the People of the United States* reports that, between 1900 and 1910, rents were 8.3 percent of national income. The difference between those two numbers raises some question of exactly what is the correct number for the early years of the last century, but it seems certain that rents then were much larger than the 2.2 percent of national income they represented in 2009. In other words, the role of rent, and presumably the importance of land, has *dropped* substantially.

What about his second bit of low-hanging fruit — technological breakthroughs? Cowen presents Pentagon physicist Jonathan Huebner's measure of technological change: the number of innovations in a year divided by the population. Huebner shows that this measure peaked in 1873, then fell, and then plummeted further after 1955. Of course, any ratio can fall for two reasons: the numerator falls or the denominator increases. Given that the measure fell by about 60 percent after 1873 but world population quadrupled, the number of innovations per year actually rose by 60 percent. But it is not clear why Cowen's and Huebner's measure, innovations *per person*, should be accepted as the right measure of technological change. If the population quadruples but innovations stay constant, can't each innovation potentially be used by everyone? So an *increase* in the number of innovations per year would mean more technological breakthroughs. Moreover, how does Huebner measure the number of innovations? Clearly, a new app for the iPhone would not count, or else the

number of innovations would be higher this year by about three orders of magnitude. But some iPhone apps probably *should* count.

To deal with the arguments of “technological optimists” (my term) who think that the Internet has revolutionized and will further revolutionize the economy, Cowen has a chapter titled, “Does the Internet Change Everything?” Of course his answer is no. That would be any sensible person’s answer — not *everything*. But Cowen considers only a narrow range of things that the Internet *has* changed. He views the Internet mainly from the perspective of a direct consumer and hardly at all from the viewpoint of producers who use it as an input. He writes that you do not benefit from the Internet “automatically in the same way you do from a flush toilet or a paved road.” Yes, you do. Virtually everyone in America does every time he pays a bill online, makes airline reservations and compares fares online, or buys goods from online companies that have used the Internet to cut costs in their production process. Cowen might dispute my first two examples on the grounds that people benefit only by choosing to use it — but is that not also the case with paved roads and flush toilets?

Cowen points out that producers on the Internet do not create huge revenues or many jobs. But this simply means, as Cowen seems to recognize, that people receive a large “consumer surplus” from the Internet. This huge consumer surplus also means that the slowing in the growth of median income understates the growth of real income properly measured. But a quick reader can get the misimpression that Cowen regards this absence of revenue and jobs as a bad thing rather than a good one. One statement that adds to this misimpression is that relatively small producer revenue from the Internet makes it “harder to pay our debts.” That is false. By making entertainment and communication cheaper, the Internet helps us avoid, if we wish, getting into debt in the first place. It is also hard to square this large, unmeasured-by-government consumer surplus with the title of Cowen’s book, and even more so the subtitle. “Got Sick”? If that is sick, I want pneumonia.

The subtitle makes it sound worse than the Great Stagnation. It makes it sound like the Great Regression.

To buttress his case for technological pessimism, Cowen presents Stanford University economist Charles I. Jones’ finding that 80 percent of the growth from 1950 to 1993 came from previously discovered ideas in a way that “cannot be easily repeated in the future.” But the future is, by definition, unknowable. Cowen could be right, but he could be wrong.

Cowen’s third factor in the disappearance of low-hanging fruit is the high percentage of people who attend college. I found this factor more persuasive. He points out that in 1900, only 6.4 percent of high-school-aged Americans graduated from high school. That number peaked in the late 1960s at 80 percent, he notes, and has fallen to about 74 percent more recently. Also, in 1900, only one quarter of one percent of Americans went to college, whereas 40 percent of people aged 18 to 24 are in college today. In other words, there is not much room for improvement in educational attainment and, as he notes, the marginal college student today “cannot write a clear sentence, perhaps cannot read well, and cannot perform all the functions of basic arithmetic.”

This suggests a huge piece of low-hanging fruit right in front of his nose: the number of people going to college. Cut that number dramatically and many of the “marginal students” would get jobs doing something productive — as plumbers, as electricians, or in any of a number of occupations that do not require a college degree. I say this not as a central planner who wishes to decree who shall attend college and who shall not, but as a defender of people’s right to use their income and wealth as they see fit rather than being forced to subsidize the education of others. Cut that subsidy to zero and cut taxes accordingly, and you would increase the after-tax income of many people, including the median family, and substantially reduce the number of marginal college students. If a marginal student still wants to go to college and he or his family or someone else he persuades wants to pay for it, then let him.

But rather than advocating cutting back on the number of students attending college, Cowen advocates more. “Educating these students is possible, it is desirable, and we should do more of it,” he writes, even though the returns from doing so are “highly uncertain.” When I teach economics, I teach my students that when the marginal cost of something exceeds the marginal benefit, we should cut back on the activity, not increase it. What does Cowen teach?

As I noted earlier, for Cowen to explain why the growth in median incomes fell, he needs to point to factors that would not cause the growth in real GDP per capita to fall. I do not think he has done that. As noted, his first explanation, the disappearance of free land, is not a good one. He could be on firmer ground with his measure of declining innovation, but he does not really make the case. He gives examples of innovations that benefit mainly higher-income people, but gives no aggregate data showing that that is what happened.

More missed fruit | This is not to say that *The Great Stagnation* lacks insights. One insight is that whatever you think of government, additions to government spending are likely to be less valuable as the government spends more. As I noted, I wish he had applied that to government spending on schools. Another insight is his idea that the reason so many successful economies got that way via exports is that the “external world market provides a real measure of value.” Whoever buys your exports has “no concern for your welfare” and “is spending his or her money to buy your product.” Unfortunately, those insights do not much help him make his overall case.

But what if he had made his case? What if, for example, he had shown that technological progress has slowed? Would it not be natural for Tyler Cowen, who understands and appreciates the power of economic freedom, to argue for more freedom?

Take the industry I am most familiar with: pharmaceuticals. Technological progress really does seem to have slowed in that industry. One of the culprits, which

Cowen's George Mason University colleagues Alex Tabarrok and Daniel Klein have written about, is the Food and Drug Administration. The FDA keeps upping the hurdles drug companies must jump before they are allowed to sell their drugs. We could get a substantial increase in drug innovation by eliminating those hurdles. The way to do so would be to end the FDA's monopoly power over drugs and allow private certifiers.

Do U.S. governments at various levels prevent similar innovation in other indus-

tries? The size of the annual *Federal Register* makes me suspect that they do. Cowen states that we will have more scientific discoveries and innovations if we respect scientists more. He is probably right. But you show them the ultimate respect when you do not make scientists and other innovators beg government to approve their innovations. Disappointingly, Cowen discusses none of this. He has missed the low-hanging fruit of deregulation.

He misses another piece of low-hanging fruit right in front of his nose: govern-

ment spending in general. Government consumption spending, health spending, and education spending, he writes, exceed 25 percent of GDP, and all three, he claims correctly, "are sectors where there is massive government distortion of incentives." It follows that reducing all three of these — I have already discussed education — would improve economic well-being for families. The 25 percent number is so big that a massive reduction is likely to raise median family income. That would be a Great Progression. R

IN REVIEW | WORKING PAPERS

BY PETER VAN DOREN

Collapse of Shadow Banking

- "Financial Policies, Investment, and the Financial Crisis: Impaired Credit Channel or Diminished Demand for Capital," by Kathleen M. Kahle and René M. Stulz. February 2011. SSRN #1754660.
- "Comment on Gorton and Metrick," by Andrei Shleifer. *Brookings Papers on Economic Activity*, Fall 2010, pp. 298–303.

In previous reviews, I have discussed the work of Gary Gorton, professor of finance at the Yale School of Management. He argues that the financial crisis of 2008 is best understood as a "run" on the overnight asset repurchase ("repo") market, the equivalent of a corporate checking account regime that developed outside the regulated banking system. For Gorton, the solution to the crisis is to bring the repo market back within the regulated financial system. Two recent papers throw some cold water on his proposal.

In one of those papers, Kathleen Kahle and René Stulz examine three hypotheses that have been offered to explain the events of 2007–2008. The Gorton argument is an example of the "credit supply shock" hypothesis — investors, such as the corporations in the repo market, lose faith in the market and withdraw their money, leaving borrowers unable to roll over their debts. In credit contractions, net debt would decrease; net equity would increase; and dividends, share repurchases, and cash holdings would decrease. A second hypothesis involves the "demand shock" in the housing market. The drop in demand for housing, exacerbated by the increase in oil prices in 2006, results in a decrease in debt and equity issuance because firms are worth less. Cash holdings increase only to the extent that decreased cash flow is offset by even lower investment. The third hypothesis involves an increase in "risk," resulting in a decrease in debt and equity, and a hoarding

of cash. The three hypotheses are not mutually exclusive.

Kahle and Stulz tested the three hypotheses on corporate quarterly data about debt, equity, and cash. If credit suddenly disappeared, bank-dependent firms should have shown different results on use of debt, equity, and cash. More-bank-dependent firms would have issued less debt, used more cash as a substitute (which means that they would have held less cash), issued more equity, and invested less than firms that were less dependent on banks for credit.

The data show that, overall, more debt was issued before September 2008 (the height of the financial crisis, when Lehman Brothers declared bankruptcy and Congress balked at passing the Troubled Asset Relief Program) and much less was issued afterward, but there was no difference in behavior among bank-dependent firms. Net equity decreased overall before net debt, but again there was no change in behavior for bank-dependent firms. Cash did decrease for bank-dependent firms before September 2008, but after that time cash holdings increased or stayed the same in all sub-samples of firms. Capital expenditures did not vary by bank dependency.

None of those findings is consistent with an exogenous bank credit contraction. Instead, the findings suggest a first-order effect of the decrease in demand (a recession) and increase in risk, rather than an exogenous reduction in the availability of credit.

Shleifer, in a comment in the *Brookings Papers on Economic Activity*, summarizes Gorton's arguments very well. First, the point of securitization was to engage in maturity transformation, linking the demand for short-term finance to longer-term collateral. Second, the abrupt withdrawal of short-term finance was the cause of the financial crisis because the underlying assets had to be sold to raise cash quickly. Third, repo is particularly guilty among short-term finance techniques because it was bankruptcy-remote — the sudden withdrawal of cash was not subject to the usual freeze and claw-back provisions of bankruptcy. Fourth, the cure is regulation

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of the repo market through government-rated collateral, as well as the institution of “narrow” banking that invests only in asset-backed securities (ABS), in return for which the narrow banks receive bankruptcy-remote privileges.

Shleifer’s critique of Gorton has many components. First, not all — nor even most — ABS served as collateral for short-term repos. The rest were sold to long-term investors. Second, the repo sell-off was a consequence of the recession, not the cause. Third, singling out the repo market for regulation is not consistent with the data because commercial paper also rose and fell in a pattern similar to repos, and commercial paper does not enjoy bankruptcy privileges and is not a new product. Fourth, ABS are used to collateralize only a small share of repo arrangements. Fifth, the policy solution proposed by Gorton — that a new, regulated institution be created that would purchase only ABS and in turn be bankruptcy remote — would eliminate all long-term sales of ABS to investors.

Shleifer believes that the market as a whole did not understand and missed the risks in housing ABS, and thus singling out repos in the policy response is inappropriate. As long as market participants do not understand the risks of the securities that they are buying, whether these securities are ABS or prime money market fund shares or something that will be invented in the future, and as long as they see profit opportunities where there are none, the financial system will adjust to meet their demand, threatening the stability of the financial market. Shutting down just one mechanism whereby investors and intermediaries pursue their profits is unlikely to protect that stability. They will try to realize their dreams through other shaky instruments instead.

Airlines

■ “On the Persistent Financial Losses of U.S. Airlines: A Preliminary Explanation,” by Severin Borenstein. January 2011. NBER #16744.

In the late 1970s and early 1980s, both interstate passenger airlines and freight railroads were freed from federal regulation of entry and pricing decisions. At the time, railroads were clearly in worse shape; one government corporation, Amtrak, had taken over most U.S. passenger rail while another, Conrail, operated freight rail in the Northeast after the bankruptcy of the merged Pennsylvania and New York Central railroads. But in the 30 years since deregulation in 1980, railroads surprised most informed observers and thrived. (See “The Staggers Act, 30 Years Later” and “Railroad Performance under the Staggers Act,” Winter 2010–2011.) And even Conrail was reprivatized successfully.

The same has not been true of airlines. From 1979 to 2009, cumulative U.S. airline losses on domestic operations were \$59 billion (in 2009 dollars). In the early deregulatory years from 1979 to 1989, there were \$10 billion in losses. The industry turned around, temporarily, in the 1990s, realizing \$5 billion in profits. But from 2000 to 2009, airlines incurred \$54 billion in losses.

The economic track record of airlines is dismal and yet, every year from 1979 to 2001, the industry saw an average increase in

fleet size of 4.9 percent as measured by aircraft and 3.6 percent as measured by seats. Some downsizing has occurred since 2001, as the number of aircraft has fallen by 1.7 percent and the number of seats by 1.4 percent, but one would expect even greater retrenchment.

Severin Borenstein finds this state of affairs to be very puzzling. “There is no conventional long-run equilibrium explanation for an industry that perpetually loses money,” he writes in this working paper.

Borenstein examines several disequilibrium theories that analysts have offered for the financial difficulties of airlines. Industry executives argue that ticket taxes and fuel prices are the problem. Taxes as a percentage of fares have increased from 8 percent in the 1980s to about 16 percent today — but (not counting the 9/11 security fee) that is the result of fares going down, not taxes going up. Concerning fuel prices, aviation fuel was below \$1.40 a gallon from 1986 to 2004, yet the industry experienced losses in 13 of those 19 years.

Demand shocks are a plausible explanation for the losses during the 2000s. Demand in 2008 was 3 percent lower than in 2000. Rescaling operations in response to a fuel price shock while demand is flat or declining is much more difficult than responding to fuel price shocks when demand is increasing.

What role does the entry and expansion of low-cost carriers like Southwest and JetBlue play? The legacy carriers blame their low-cost rivals for excess capacity in the industry, but the data suggest that the legacy carriers have been responsible for more capacity. Another way of looking at low-cost carriers is that they are making a very slow attack on legacy carriers. Adjusted for trip length, legacy carrier costs have been 30–60 percent higher since deregulation occurred, and 40 percent higher in the 2000s.

What is the source of that cost difference? The data suggest that better labor and capital utilization, rather than lower labor or fuel costs per se, is the source of the low-cost carriers’ advantage.

Legacy carriers have had consistently higher costs since deregulation, but their reputations have allowed them to charge a price premium. However, that premium has eroded by 60 percent over time, resulting in persistent losses. The legacy carriers either have to lower costs or regain their ability to charge more.

Peer Effects in Education

■ “From Natural Variation to Optimal Policy? The Lucas Critique Meets Peer Effects,” by Scott E. Carrell, Bruce I. Sacerdote, and James E. West. March 2011. NBER #16865.

Education policy analysts have long argued that, at least to a certain point, the mixing of lower- and higher-ability students is a Pareto improvement — that is, lower-ability students improve their performance following such mixing, while better students do not experience a decline in theirs. However, these analysts add, this mixing does not occur under free choice; parents of higher-ability students will gravitate toward “better” school districts. Thus, many of these analysts argue that coercion should be used to alter the ability composition of

classrooms to improve educational outcomes.

The role of mixing and sorting was recently tested at the Air Force Academy, where coercion is possible and unquestioned. All freshmen take the same classes and exams, and are randomly assigned to professors and sections. The authors of this working paper examined the results of that mixing by estimating regressions explaining first-year grade point average. They found that low-ability students benefited from random increases in the number of high-ability peers.

The authors then ran an experiment in which half of the class members were assigned sections in the usual random way and the other half were assigned to maximize the probability that those with predicted grades in the lower-third of the class mixed with high-ability (upper-third) students. But the results in the experimental group were worse than the control group. How is this possible?

One possibility was just bad luck through sampling variation. But the probability of that is less than one in 1,000.

Another possibility is that peer interactions changed at the time of the experiment. But the authors re-estimated the regression on the participants in the control side of the experiment and got a positive effect similar to that found in the original empirical work.

A final possibility is that the experiment changed peer dynamics. At the Air Force Academy, students are not allowed to select roommates in the first semester but they are allowed to choose in the second. The researchers found that, in the experimental group, low-ability students chose fellow low-ability students to live and study with, and those choices likely undermined the expected effect of the experiment.

For those searching for the elusive magic policy bullet to remedy low academic achievement, the results of this study are quite sobering. The amount of coercion required to alter outcomes goes well beyond the classroom. And if the required coercion is not practical in a military setting, how could it be possible in a civilian context?

Merger and Acquisition Economics

■ “Productivity, Restructuring, and the Gains from Takeovers,” by Xiaoyang Li. March 2011. SSRN #1777464.

Economists argue over whether the gains to shareholders from mergers and acquisitions come from efficiency gains or wealth redistribution in the form of breaking implicit worker compensation contracts within the acquired firm. To resolve that argument, Xiaoyang Li examined 1,430 mergers from 1981 to 2002 using plant-level data. He regressed announcement

returns on changes in payroll and changes in total factor productivity (TFP). He found a positive relation between announcement gains and TFP, but no relationship with changes in payroll. Thus it would seem that efficiency and not redistribution is the source of the gains.

Li also compares productivity in acquired firms relative to firms where a merger was announced but not consummated. Target plants experienced a 1.5 percent increase in TFP relative to failed merger plants, 10–12 percent less capital expenditures, and 1–2 percent lower labor costs in managerial positions. The gains to shareholders were two to six times the reductions in payroll cost, suggesting much more than a wealth transfer. Li concludes that acquirers improved target firms’ TFP by reducing inputs and keeping outputs constant, largely reducing management rather than production workers.

Low-ability students chose fellow low-ability students to live and study with, likely undermining the expected effect of the experiment.

Generic Drug Entry

■ “Earning Exclusivity: Generic Drug Incentives and the Hatch-Waxman Act,” by C. Scott Hemphill and Mark A. Lemley. January 2011. SSRN #1736822.

Under provisions of the Hatch-Waxman Act, the first generic drug applicant to file with the Food and Drug Administration gets 180 days of exclusivity after entry before other generic manufacturers may enter the market — a sort of “mini patent period” for the first generic. The intention of the provision is to provide additional incentive for generic drug companies to challenge weak patents rather than just wait for patent expiration.

An unanticipated response to this provision has been contracts between the manufacturers of patented drugs and generic drug manufacturers, whereby the generic firm that wins the first-to-file right agrees to delay entry in exchange for a payment from the patent holder. Under the law, even with the agreement, the generic company still retains the 180-day exclusivity right when it finally does enter the market. As a result, the intention of the provision is violated and society loses out because the price premium received by the generic firm over those 180 days does not reflect lost consumer surplus. Entry, in effect, has public good characteristics and a private contract not to enter reduces social welfare.

In the early years of implementing Hatch-Waxman, the FDA awarded 180-day exclusivity only if a client successfully ended a patent early through a successful lawsuit. Exclusivity was awarded only three times between 1984 and 1998, when the Supreme Court ruled against the FDA’s “end the patent” rule.

The authors of this working paper argue that reform should hearken back to the original FDA rule. Congress should amend the law so that 180-day exclusivity should come only for actual entry, rather than just the first application to the FDA. **R**