Economics

Department Alumni Newsletter

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Bob Stonebraker, editor

Nicknames, Mascots and Other Creatures

The *Great Mascot/Nickname Fracas* has ended. For now.

It was a classic struggle. The forces of political correctness arrayed in battle against the *Good Old Boys*. Luckily, with weaponry limited to righteous indignation, bluster and heavy breathing, casualties were contained. Minor mutilations, but no fatalities.

And, with the dust settled, we're still the Indians. No Crimson Thunder or Crimson Hawks or my personal favorite, Crimson Scholars. Just plain old Indians. Status quo. Ah. But, we do have a new mascot. A bear.

A bear? Huh? Well..... Bears *are* prominent in many Native American legends. And, bears *are* indigenous to the Indiana area. And, no recognized organization stepped forward to object to or to decry ursine defamation. So, a bear it is.

But, what bear? Could it at least be an academic bear? An erudite bear? A bear culled from the pages of literature or science? *Winnie-the-Pooh*, of course, won't do. He is, by his own admission, a bear of very little brain and, therefore, inappropriate for an upscale institution of learning like IUP. Yogi Bear appeals to me -- I identify with his fetish for picnic food. But, he and pal Boo-Boo are proprietary, and Hanna Barbera is not likely to cede them to IUP without a fight.

And in the department...

We're doing very well, thank you. Spirits are high. We have started to recruit more aggressively and the number of economics majors has begun inching up. Last summer, with the help of the Pennsylvania Partnership for Economic Education, we offered a one-week residential workshop in economics for talented high-school students. We even had State Secretary of Education Hickock on campus to check us out. What a blast. And it worked. One participant has already indicated she's interested in coming to IUP as an economics major. Even better, thanks to a generous grant from T.W. Phillips Gas and Oil, we are able to offer the program again this summer in a new and improved format.

And, we continue to innovate. Our new *Economics of Sports* course, offered by Arthur Martel and Nick Karatjas, is a hit, as is Will Radell's *Visual Economics*. John Cross is using his sabbatical leave to create *The Economics of Crime*. It's on the books for Fall and is filling rapidly with criminology majors hunting an open elective. What's next? We're ready to rethink our entire curriculum. Are we offering the right courses in the right sequence? Are our requirements appropriate? Any ideas? Let us know.

Bob Stonebraker, editor

What's a Euro

by
Yaw Asamoah

Multiple choice. Is a *euro* a car? A country? A color? A constellation? Or, a currency?

You're right. It's a currency; a currency now shared by the eleven member nations of the European Currency Union (ECU): Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Greece is likely to join in the near future when it meets the needed prerequisites. Although the national currencies will remain in circulation for the next two years until euro notes and coins are introduced in January 2002, banks will offer accounts in euros and prices will be quoted both in euros and domestic currency.

Why? Why would a country willfully abandon its domestic currency? What do these eleven nations stand to gain? And, why did Britain, Denmark and Sweden chose not to join their European brethren? Are there risks? If so, what are they? Have other *currency unions* been successful?

The benefits of union

Several factors make the idea of belonging to a currency union attractive:

....*Lower transaction costs*. Frenchmen and Italians will be spared the headache of exchanging francs into liras in order to trade with one another. International tourists will no longer be slowed by standing in line to exchange money at each border and by continual fumbling for the "right" currencies. Also, with the prices of Volkswagens, Fiats and Peugeots all denominated in one currency, consumers will be able to compare prices far more quickly and accurately.

....*Less risk*. Planning will be easier. Irish farmers will no longer fret about whether the Irish pound might depreciate relative to the Italian lira just as they embark on that vacation to Venice. For firms, a single currency means greater certainty of investment returns. Businesses will be able to make investment decisions in Europe with less worries about a possible movement of, say, the Spanish peseta against the Dutch forint.

....*Greater competition*. A single currency and more-easily-compared prices will intensify competition among firms. Consumers will find it easier to shop around and compare deals across international borders.

....*Integrated capital markets*. The euro might create a single, flexible capital market that would better fund corporate retooling and expansion in Europe. German investors will find it easier to buy stocks in a Finnish company. Financial markets will be integrated to become larger, more efficient and competitive so that a larger proportion of French, Italian and German corporations will be able to raise funds directly from households through the equity markets. Easier access to equity financing would mean lower costs of financing investment projects, less corporate dependence on commercial banks, and greater investor participation in stock markets.

....*Speedier economic growth*. Lower costs, safer investment returns, enhanced competition, and more efficient capital markets should all lead to increased economic growth.

The drawbacks

But, there is another side. The formation of a currency union is not a risk-free venture. Far from it. Indeed, the possible flaws were severe enough to keep several invited countries, most notably Britain, on the sidelines.

Members of the ECU (or the Euro-11, as they are commonly known) have given up their authority to pursue an independent monetary policy to a supra-national central bank, in this case, the European Central Bank (ECB). Why is this a big deal? The possibility of using a monetary stimulus by each national government in the event of a recession is now out of the reach of the national policymakers. That authority now resides in the hands of Dutch banker Wim Duisenberg, the chairman of the ECB.

In terms of his independence, and the lack of a formal mechanism for accountability, Duisenberg is the most powerful policymaker in Europe. His charge is to fight inflation in the euro-zone; he is not accountable to the European Parliament; and he is less likely to be swayed by the problems in some isolated corner of the region; especially a non-Dutch corner.

Fiscal policy is similarly handcuffed. To join the EMU, each nation had to agree to a *Stability Pact* which requires them to keep federal budget deficits under tight control. Should a recession strike an individual country, it will be unable to pump up demand with a flood of new government spending projects.

To make matters worse, national policymakers in the Euro-11 have also sacrificed the use of exchange rate adjustments as a way of stabilizing their domestic economies. In the past, each government had the ability to devalue its currency during times of recession in order to boost exports and increase domestic demand for import-competing goods.

In other words, the normal policy tools needed to fight a recession are gone. With no power to pump up demand with new money or with new federal spending or with new exchange rate adjustments, recessions in an individual country could become far more severe.

Optimal currency areas

Is this lack of policy flexibility a particular problem of the European Currency Union? Are all currency unions doomed to fail? Not necessarily. Remember, fifty U.S. states share a common currency quite successfully. Those unions which are carved out of what economists call an *optimum currency area*, work well. Others do not.

An optimum currency area requires a collection of states or countries to meet two criteria. First, *their economies must be well integrated.* Since members cannot pursue independent macroeconomic policies, it is critical that they face similar macroeconomic scenarios. The economies of the component regions must be very well integrated, so that, rather than occurring in insulated, non-synchronized pockets, changes in economic activity tend to take place across the entire area. Second, *their markets must be flexible enough to weather economic shocks*. Shocks or disturbances that do occur should be remedied fairly quickly.

In the United States, these criteria are met. The economies of our various states are well-integrated, and markets are flexible enough to effectively fight shocks to individual areas.

For example, suppose the closure of a naval yard in Groton triggers a slump in the Connecticut economy. What would happen? First, to protect their jobs, workers in Connecticut would accept wage cuts as the downturn begins. Workers who do get laid off would relocate to other states where job

opportunities are more numerous. Second, Connecticut residents would qualify for a variety of federal subsidies paid for by taxpayers in states with more robust economies. Increased federal transfers for welfare payments, for food stamps, for housing and educational supplements would all help ease Connecticut's distress. Finally, dividend payments to Connecticut households who own stocks in firms located elsewhere in the U.S. would help compensate for the low profits of Connecticut-based companies.

Will it work in Europe?

However, Europe differs from the U.S. in substantive ways. Does the euro-zone have what it takes to be an optimum currency area? Most analysts think not. Economies in the Euro-area are not closely integrated enough to promote synchronized swings in business activity. Besides, European labor markets are inflexible. National policies protect most workers from wage cuts that may become necessary during a recession. Moreover, few European families would move from their county of residence; much less to another country. Is an unemployed Irish worker likely to go job-hunting in Spain with its alien language and culture? No chance.

In addition, the ECU has no power to transfer income from prosperous nations to relatively depressed ones. Can you imagine the French leaping at the chance to truck their tax dollars to Helsinki in the event of a Finnish economic slowdown? What is worse, relatively few European households own stocks, and those who do rarely buy shares in firms based outside their own country.

If an isolated recession strikes a particular country like Portugal, the European Central Bank may not care. The ECB mandate is low inflation. It cannot flood Portugal with new bank reserves and credit without potentially triggering higher inflation throughout the rest of the ECU region. But, if Portuguese policymakers cannot rely on the ECB riding to their rescue, and if rigid wages and immobile workers thwart free-market solutions to unemployment, look out. Portugal will fall into a prolonged slump.

Can the fledgling ECU tolerate such pressures? Time will tell.

Let the Good Times Roll...

Oh, happy days. We are riding what is about to become the longest economic expansion of this century. Soaring stock prices have created unprecedented financial wealth. The unemployment rate has plunged to a thirty-year low, and *Help Wanted* signs beckon potential applicants in storefronts across America. Gasoline prices plunged even farther than my hairline and inflation seems but a faded memory. Times are great.

Or are they? Although our economic tide is rising, the seas are rough. Well-appointed economic boats are cresting to record levels, but those less seaworthy have been swamped by the waves and capsized. Skippers skimming along the surface are smiling; those stuck in the muck below are not. Median incomes have soared, but so has income inequality.

Check out the following table. It lists shares of total U.S. income by quintile. If income was distributed equally, each 20 percent of households would control exactly 20 percent of U.S. income. What we find, however, is that the richest 20 quintile has cornered half of the U.S. income. The richest five percent reaps almost twice the annual earnings of the bottom 40 percent. U.S. income is distributed unequally; more unequally than in most other developed nations. For example, the richest quintile in Japan controls less than 40 percent of national income (compared to almost percent in the U.S.), while

the poorest quintile in Japan receives more than eight percent of national income (compared to less than four percent in the U.S.).

* *

Shares of Total U.S. Income

Households	*1967*	*1977*	*1987*	*1997*
Poorest 20%	4.0%	4.2%	3.8%	3.6%
2nd quintile	10.8%	10.2%	9.6%	8.9%
3rd quintile	17.3%	16.9%	16.1%	16.0%
4th quintile	24.2%	24.7%	24.3%	23.2%
Richest 20%	43.8%	44.0%	46.2%	49.4%
Richest 5%	17.5%	16.8%	18.2%	21.7%

* *

And, the degree of inequality has increased. Over the last two decades, the share of the poorest 20 percent has slid while the share of the richest 20 percent has climbed. In 1977, the richest 20 percent controlled about ten times as much income as the poorest 20 percent. By 1997, the top 20 percent was bringing in more than 15 times the income of the bottom 20 percent.

Some dispute that inequality has grown. The table includes only *money* income; *non-money* income in the form of food stamps, housing subsidies and medicare/medicaid benefits is ignored. Including these would reduce both the amount of and trend in inequality.

Lower tax rates might also have distorted the data. Conservatives suggest that when tax rates fell through the 1980's, the incentive for wealthy citizen's to hide income from Uncle Sam also fell. If so, much of the apparent increase in upper-level incomes might be illusory. If financial fat cats suddenly pull earnings out from under the table, *reported* income inequality may rise even though *actual* inequality is unchanged.

Increased wage differentials

But, these are minority impressions. Most analysts agree that the expanding gap between the rich and the poor is very real. And, most agree that increased wage inequality is the cause. According to Harvard's Larry Katz, increased wage differentials account for almost all of the increased income differentials between the rich and the poor. Highly skilled and educated workers have prospered; less-skilled and less-educated workers have not. Why?

Can we blame those foreigners? Some have. Globalization forces countries to specialize in those sectors in which they have a comparative advantage. For the U.S. that means concentrating on products that make intensive use of skilled labor and importing goods and services produced primarily by unskilled labor. The result? Increased globalization and trade should create increased demands and wages for skilled workers in the U.S., and decreased demands and wages for unskilled workers.

Sound reasonable? It is. Unfortunately, the evidence will not cooperate. If trade is the culprit, unskilled workers in industries besieged by imports should be especially hard hit. They are not. Do we travel to Venezuela to shop for chewing gum or swimsuits? Do we call Malaysian contractors when soliciting bids to re-roof your garage? No. Sectors such as retail trade and construction are relatively

immune to foreign competition. Yet, unskilled workers in these sectors have fared no better than those producing traded manufactured goods. Moreover, unskilled workers in other countries have fared just as poorly as those here at home. Despite our best efforts, we cannot trace any significant part of the blame to international trade.

Technology?

How about technology? Much of the technological change in recent decades has been "skill-biased;" it impacts skilled and unskilled workers differently. For example, the computer revolution has increased the productivity of skilled workers, but blown unskilled ones out of the water. Skilled, computer-literate applicants job hop to ever-increasing salaries. Former clerks and assembly-line workers, now displaced by computers and robots, pound the pavements unable to replace their former wages.

Cornell's Bob Frank suggests that technology might increase inequality through other channels as well; it might increase the importance of *winner-take-all markets*. In most markets, a worker who is five percent more productive than another might expect to earn a salary which is five percent higher. But in winner-take-all markets, very small differences in absolute productivity translate into enormous pay differentials.

In the Darwinian struggle for survival, a small *relative* edge can make all the difference. The rabbit who survives doesn't have to be very fast, as long as he is faster than the fox in pursuit. My attorney doesn't have to be very talented, as long as she is more talented than the one representing my adversary. The local baker might turn out *average* bagels, but can still corner the market if those of its competitors are worse.

Winner-take-all markets breed inequality, and technology -- especially improved systems of transportation and communication -- breeds winner-take-all markets. Technology has transformed markets. Instead of moderately-wealthy stars in fifty separate regional markets, we now have one filthy-rich star in a single national market. Why watch the local minor-league baseball team when the major league champion beams its games over satellite TV? Why pay to hear a local singer when Mariah Carey's latest smash hit is available on a compact disk?

Rabo Karabekian, the protagonist of Kurt Vonnegut's *Bluebeard* put it brilliantly. Reflecting on ancient days in which each community had its own story-tellers, its own artists, and its own musicians, Karabekian laments:

> *.....a scheme like that doesn't make sense anymore, because simply moderate giftedness has been made worthless by the printing press and radio and television and satellites and all that. A moderately gifted person who would have been a community treasure a thousand years ago has to give up, has to go into some other line of work, since modern communications put him or her into daily competition with nothing but world champions. The entire planet can get along nicely now with maybe a dozen champion performers in each area of human giftedness.*

Solutions?

If technology is a key ingredient, it should not be a surprise that other develop nations have

experienced similar increases in wage inequality. Interestingly, other nations have moderated these effects through increased government transfers to low-income families. The U.S. has not. In fact, recent U.S. welfare reforms have cut back on such assistance.

Many U.S. taxpayers favor assistance to low-income families, but resist those that tax the middle class to do so. Taxing the rich is acceptable, squeezing the middle class is not. Because most families are convinced that they are middle class and that someone else is rich, few redistributive programs pass political muster.

What do the data say? What does it take to be rich? In 1997, median household income was $37,005. Households with incomes above $71,500 were in the richest 20 percent; those with $126,550 ranked in the richest five percent.

Hmmm. These are not disgustingly large numbers. Experienced full professors at IUP earned enough to propel them into the richest quintile. Many IUP students come from families that would rank in this same top 20 percent. I often tell my colleagues and students that they are rich. I explain they are among the richest households in the richest country the world has ever seen. They are not amused. They do not feel rich. They do not want to be thought of as rich. Yet, they are rich. So are, or will be, many of you.

Is income inequality increasing? Yes. Is such inequality a problem? Probably. But, that is a value judgement which you may or may not accept. Can we assist the poor without squeezing the middle class? Only if we define *middle class* honestly. If we persist in assuming that only candidates for Robin Leach's *Lifestyles of the Rich and Famous* should be squeezed, we are dead in the water.

Saving Lives Can be Dangerous

In the halcyon days of my youth, I suffered repeated tennis thrashings at the hands of my friend Jimmy. A brilliant, albeit mercurial player, Jimmy had a nasty habit of smashing his wooden racquet against hard surfaces when serves and volleys failed to behave appropriately. *[I grew up in the distant, pre-composite past when all tennis racquets were constructed of wood.]* The consequent result? A succession of fractured frames.

No matter. Jimmy's parents always came through with the funds for a new racquet. Which, of course, is why he was willing to unleash his temper at the drop of a double fault. Jimmy never *wanted* to break his racquets -- there was always a transitional between-racquets phase he disliked. However, his parent's pocketbook provided an insurance policy that minimized his potential loss. It's simple economics. When parents lower the cost of broken racquets, the quantity of broken racquets produced will rise.

Moral hazard

If insuring against racquet breakage increases the number of broken racquets, might other insurance programs have similar effects? Of course. Insurance companies are all-too familiar with the quandary. Insurance alters incentives. Once we are heavily insured against an adverse event, we have less incentive to avoid that event.

It's the problem of *moral hazard*; because the insured no longer bears the full cost of a disaster, fewer precautions will be taken and the likelihood of disaster increases. For example, theft insurance

might induce us to take fewer safeguards with our valuables. If we know our losses will be replaced, will we be as zealous in locking our doors? Will we invest as readily in that new home security system?

Similarly, government flood insurance might allow victims to rebuild homes on flood plains where they are likely to be reflooded. Indeed, the run-off from melted snows this Spring will swell local waters and inundate downstream homes. When television reporters swarm to the scene of the disaster, listen to their interviews of flood victims. Many victims will have been flooded before, and many will be flooded again.

The more heavily we insure against an event, the more likely that event becomes. When urban riots lowered inner-city property values in the late 1960's, many undamaged buildings ended up with market values that were significantly below their insured values. At the same time, losses from fires in these inner-city areas rose rapidly. Was it coincidence? Or, was it moral hazard in action?

Is there a solution to moral hazard? Perhaps. Insurance companies combat the problem with deductibles that force insured individuals to bear part of the cost of accident or theft. Safety inspections and discounts for policy holders that take certain precautions, such as installing smoke alarms, are also common. However, as long as insurance bears part of the cost, part of the problem will remain.

The notion that theft insurance might lower precautions against potential burglary is relatively easy to see. But, does the problem extend beyond property insurance? What about harm to life and limb? Might people with heavy health and life insurance behave more recklessly than those without? Does moral hazard extend to life and death decisions?

Saving lives

Yes. If the cost of harm goes down, people's willingness to risk life and limb goes up. Suicide offers an extreme illustration. To avoid problems of moral hazard, firms routinely exclude life insurance claims for individuals committing suicide. But other, less obvious, examples abound.

Few actions seem so noble as rescue operations. Workers, often unpaid volunteers, risk their own lives to pull injured or stranded victims from countless perils. Is it worth it? What if rescue operations reduce the risk of dangerous activities. What if the expectation of rescue induces more people to engage in risky behavior? Might the expectation of Park Service rescue encourage more ill-prepared hikers to venture more deeply into dangerous back country? Might Coast Guard rescues encourage more boaters to sail more brazenly into the open sea under storm clouds?

The impact of such rescues could be perverse. Suppose rescue operations lower the risk of mountain climbing by 40 percent. The increase in perceived safety will raise the demand for climbing mountains. More people will climb and, probably, take fewer precautions when they do. The net effect is ambiguous. If the increase in risk-taking is less than 40 percent, the rescue operations will lower overall fatalities. If the increase in risk-taking exceeds 40 percent, fatalities will rise. Rescues lower the probability that any single individual will die but, if the number of climbers increases enough, total fatalities increase. Well-intentioned rescues can kill.

According to economists J. R. Clark and Dwight Lee, government attempts to rescue climbers on Mt. McKinley illustrates the point. Prior to rescue attempts, only the most expert and best-prepared mountaineers braved its slopes. And, in these initial years, none died. When deaths did begin to occur, the government responded with increasingly aggressive rescue efforts. The result? More and poorer-prepared climbers, and *more deaths*.

At least one professional guide blames a change in attitude. Clark and Lee quote him as saying that initially, "there was more of an understanding that people were on their own. They didn't rely on others for help. But, [after] word got out that the National Park Service would pay for rescues, the prevailing attitude seemed to be 'Don't worry. If we get in trouble, the Park Service will rescue us.'"

Safety regulations

Government safety regulators suffer similar dilemmas. If regulations make our products safer, they might also induce us to take more risks with them. Safer power saws will help little if they simply create more and less-cautious users.

There is evidence that drivers become more aggressive when protected by air bags. Safety caps have not solved the problem of accidental aspirin-related poisonings. Imaginative toddlers can defeat the protective mechanisms and consumers, lulled into a false sense of security, are more apt to leave medicines with safety caps where children can reach them. In addition, because safety caps are so bothersome to adults, especially those with arthritis, the medicines are more likely to be left open.

Despite massive efforts, the Occupational Safety and Health Administration has had little apparent impact on overall workplace safety. Offsetting worker behavior could be a potential factor in any explanation.

Saving lives is an admirable ambition. But, be careful. When we change the costs or probability of harm, we also change people's behavior. Saving lives can be dangerous.

Return to the Alumni Newsletter index.

Return to the IUP Department of Economics Front Page.