

National Bureau of Economic Research (NBER) (Ed.)

**Periodical Part**

## NBER Reporter Online, Volume 1997

NBER Reporter Online

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*Suggested Citation:* National Bureau of Economic Research (NBER) (Ed.) (1997) : NBER Reporter Online, Volume 1997, NBER Reporter Online, National Bureau of Economic Research (NBER), Cambridge, MA

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SPRING 1997

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## Program Report

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### Asset Pricing

John Y. Campbell\*

Asset pricing — the study of markets for financial assets including stocks, bonds, foreign currencies, and derivatives — is a field in which there is an intense and fruitful interaction between empirical and theoretical research. The work of economists associated with the NBER Asset Pricing Program illustrates this interaction particularly well. NBER economists have been studying many different phenomena, including the high rewards that investors have received for holding stocks in general and “value stocks” in particular, the apparent predictability of stock and bond returns at long horizons, and unusual patterns in option prices. In each area, empirical puzzles have stimulated new thinking about investor behavior and the functioning of capital markets.

Financial markets are, of course, changing rapidly. NBER economists have been following these developments, and in some cases have tried to anticipate or influence them. There has been much research on international capital markets and the opportunities they present for risksharing across countries; other work has discussed new types of securities, including inflation-indexed bonds, which were issued for the first time by the U.S. Treasury in January 1997.

### Cross-Sectional Patterns in Stock Returns

Historically, investors have received handsome rewards for bearing the risk of investments in equity markets. Economists have found it difficult to rationalize the size of this “equity premium.”<sup>1</sup>

Recent research on individual U.S. stocks has uncovered facts that make this puzzle even more challenging. First, the average excess returns on value stocks — stocks whose prices are low relative to their book values, earnings,

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or dividends — are even higher than the average excess returns on stocks in general. Second, there seems to be a “momentum effect”: stocks that have outperformed the market during the last few months tend to outperform the market during subsequent months.

There is an active debate about how to interpret these phenomena. Eugene Fama and Kenneth French have proposed that value stocks deliver higher average returns because they are riskier.<sup>2</sup> Other NBER economists have challenged this view. Craig MacKinlay argues that it requires an implausibly high reward for bearing risk,<sup>3</sup> while Rafael La Porta, Josef Lakonishok, Andrei Shleifer, and Robert Vishny suggest that investors underprice value stocks because they are too pessimistic about the earnings of these companies. They show that as much as one third of the excess return on value stocks occurs in the few days around earnings announcements, suggesting that investors are on average favorably surprised by the earnings of value stocks.<sup>4</sup> Louis Chan, Narasimhan Jegadeesh, and Lakonishok document a similar tendency for the excess return on momentum stocks to occur near earnings announcements, suggesting that for these stocks also investors tend to have incorrect earnings expectations.<sup>5</sup>

Nicholas Barberis, Shleifer, and Vishny have built an explicit model of investors' irrational expectations that can generate excess returns on both momentum stocks and value stocks. In their model, earnings growth cannot be forecast, so the best forecast of future earnings is just the current level of earnings. Investors normally expect earnings to revert to some long-run average level, which leads them to underprice stocks that have experienced recent earnings growth (momentum stocks). A series of positive or nega-

tive earnings surprises, however, can lead investors to expect continued positive or negative earnings growth; this leads them to underprice stocks that have performed extremely badly (value stocks).<sup>6</sup>

## **Time-Variation in the Reward for Risk**

Financial ratios of stock prices to book values, earnings, or dividends also are used in time-series studies of the stock market as a whole. These ratios, along with other variables including yield spreads between long- and short-term or between low- and high-quality bonds, have some ability to forecast aggregate stock and bond returns.<sup>7</sup>

Shmuel Kandel and Robert Stambaugh have explored the implications of this evidence for optimal portfolio choice. Using a Bayesian framework to allow for uncertainty about the degree of predictability in returns, they show that an investor with constant risk aversion and a short investment horizon should try to "time the market," adjusting the portfolio share in stocks in response to changes in the financial ratios that predict returns. In a similar spirit, Luis Viceira and I have derived the optimal market-timing portfolio strategy for an investor with constant risk aversion and a long horizon.<sup>8</sup>

This work takes predictable variation in returns as given. Other NBER research asks where that variation comes from, and whether it can persist in the face of market-timing responses by investors. John Cochrane and I, building on the work of George Constantinides, have argued that typical investors do not have a constant aversion to risk; instead their risk aversion tends to fall when the economy is strong, because they judge their well-being by reference to recent standards of living and feel more comfortable taking risks when

their consumption is well above recent average levels. This "habit-formation" model implies that investors do not try to profit from predictable variation in returns because it is during periods of unusually low stock returns that investors are unusually willing to take on risk.<sup>9</sup> Jiang Wang has explored the possibility that different investors have different levels of risk aversion; when they trade with one another, the equilibrium reward for bearing risk can vary over time.<sup>10</sup>

Shleifer and Vishny have pointed out that even when there is no equilibrium justification for time-variation in stock returns, so that the time-variation represents mispricing of stocks, it may be difficult for rational speculators to trade aggressively enough to eliminate the mispricing. This is particularly true when an initial pricing error increases; then rational speculators who have bet on a correction of the error lose money and are forced to the sidelines. Thus stabilizing speculation tends to be weakest precisely when mispricing is most severe.<sup>11</sup>

In a study of the foreign exchange market, Blake LeBaron has shown that intervention by monetary authorities is one possible source of mispricing. He finds that technical trading rules produce profits only in periods of intervention, when monetary authorities are trading to influence exchange rates and are willing to lose money in pursuit of their objectives.<sup>12</sup>

## **Option Prices, Changing Volatility, and Market Microstructure**

Option markets offer economists a fascinating look at investors' expectations. By combining different options on a given underlying security, it is possible to construct a derivative security that pays off only if the

underlying price is in a particular narrow range: for example, only if the S&P 500 index is between 800 and 801 on a particular date in the future. Thus option prices can reveal the probabilities (adjusted for risk) that investors place on each possible level of the S&P 500 index.

Yacine Ait-Sahalia and Andrew Lo have developed a nonparametric econometric method for estimating risk-adjusted probabilities. They show that recent prices for S&P 500 index options imply high risk-adjusted probabilities of a large decline in the S&P 500 index.<sup>13</sup> David Bates has compared two possible explanations for this finding. Investors could anticipate that a decline in stock prices would increase volatility, so that over several months a large decline in the market is more likely than an equally large increase; or they could fear a "crash," an instantaneous large drop in the market. Because the risk-adjusted probabilities of a large decline in the index are high even for very short-term options, Bates concludes that investors do indeed fear a stock market crash.<sup>14</sup>

Other researchers have studied changing volatility, a pervasive phenomenon in stock and bond markets that shifts the risk-adjusted probability distributions implied by option prices. Torben Andersen and Tim Bollerslev have argued that volatility follows a complex time-series process; there are short-lived bursts of volatility within the trading day, but there are also highly persistent movements in volatility that affect asset markets for several months.<sup>15</sup> Robert Engle and Joshua Rosenberg, and Bernard Dumas, Jeff Fleming, and Robert Whaley, have shown how models of changing volatility can be used to explain the behavior of option prices.<sup>16</sup>

Studies of volatility within the trading day lead naturally to a new fron-

tier in financial economics, the study of transaction-level data. In recent years, data have become available on all trades and quotes for listed and some over-the-counter U.S. stocks. These data are stimulating the development of new econometric methods,<sup>17</sup> and they make it possible to study the properties of alternative systems for trading stocks and other assets.<sup>18</sup> A new "Market Microstructure Research Group" will meet for the first time at the 1997 NBER Summer Institute to provide a forum for empirical research in this area.

## Diversification, Risk-Sharing, and New Financial Markets

A striking fact about international financial markets is that investors tend to concentrate heavily in the stocks and bonds of their own country. This "home bias" is diminishing only slowly, and it is costly because investors give up the opportunity to diversify internationally.<sup>19</sup>

One factor that may contribute to home bias is that investors are better informed about assets in their own country than about foreign assets. Consistent with this explanation, Jun-Koo Kang and René Stulz have shown that foreign investors in Japan tend to concentrate in large stocks, which presumably are better-known overseas; while Jeffrey Frankel and Sergio Schmukler have shown that Mexican stock prices declined more rapidly in the peso crisis of December 1994 than did prices of Mexican closed-end funds traded in the United States, suggesting that Mexican investors were better-informed than U.S. investors.<sup>20</sup>

In a series of papers, Robert Shiller has argued that unexploited opportunities for diversification justify the establishment of new financial markets. Shiller and Stefano Athanassoulis, Shiller and Ryan Schneider,

and Shiller and Allan Weiss have proposed securities that could be used to trade international income risk, occupational income risk, and real estate price risk, respectively.<sup>21</sup>

While these markets do not yet exist, the U.S. Treasury has recently created a potentially important new market by issuing inflation-indexed bonds. Shiller and I have summarized the arguments that many economists have made in favor of indexing bonds and other contracts to inflation, while David Barr and I have studied the U.K. experience with inflation-indexed bonds.<sup>22</sup> Niko Canner, N. Gregory Mankiw, and David Weil have criticized the conventional wisdom that conservative investors should hold bonds rather than stocks; they point out that nominal bonds are risky in real terms. Inflation-indexed bonds offer stable real returns and thus should appeal to conservative investors with long horizons.<sup>23</sup>

<sup>1</sup> See J.Y. Campbell, "Consumption and the Stock Market: Interpreting International Evidence," NBER Working Paper No. 5610, June 1996, for a survey. W.N. Goetzmann and P. Jorion, "A Century of Global Stock Markets," NBER Working Paper No. 5901, January 1997, cautions that equity returns may be overstated by looking only at successful stock markets.

<sup>2</sup> E.F. Fama and K.R. French, "Common Risk Factors in the Returns on Stocks and Bonds," *Journal of Financial Economics* 33, 3–56.

<sup>3</sup> A.C. MacKinlay, "Multifactor Models do not Explain Deviations from the CAPM," *Journal of Financial Economics* 38, 3–28, 1995.

<sup>4</sup> R. La Porta, J. Lakonishok, A. Shleifer, and R.W. Vishny, "Good News for Value Stocks: Further Evidence on Market Efficiency," NBER Working Paper No. 5311, October 1995.

<sup>5</sup> L.K.C. Chan, N. Jegadeesh, and J. Lakonishok, "Momentum Strategies," NBER Working Paper No. 5375, December 1995.

<sup>6</sup> N. Barberis, A. Shleifer, and R.W. Vishny, "A Model of Investor Sentiment," NBER

Working Paper No. 5926, February 1997.

<sup>7</sup> A.W. Lo and A.C. MacKinlay, "Maximizing Predictability in the Stock and Bond Markets," NBER Working Paper No. 5027, February 1995, documents predictability for the aggregate U.S. market and for selected portfolios of U.S. stocks. W.E. Ferson and C.R. Harvey, "Fundamental Determinants of National Equity Market Returns: A Perspective on Conditional Asset Pricing," NBER Working Paper No. 5860, December 1996, presents similar evidence for stock portfolios from different countries. C. Engel, "The Forward Discount Anomaly and the Risk Premium: A Survey of Recent Evidence," NBER Reprint No. 1089, November 1996, and *Journal of Empirical Finance* 3, 123–192, 1996, reviews evidence for predictability in international bond markets.

<sup>8</sup> S. Kandel and R.F. Stambaugh, "On the Predictability of Stock Returns: An Asset-Allocation Perspective," NBER Working Paper No. 4997, January 1995, and J.Y. Campbell and L. Viceira, "Consumption and Portfolio Decisions when Expected Returns are Time Varying," NBER Working Paper No. 5857, December 1996.

<sup>9</sup> G. Constantinides, "Habit Formation: A Resolution of the Equity Premium Puzzle," *Journal of Political Economy* 98, 519–543, 1990, and J.Y. Campbell and J.H. Cochrane, "By Force of Habit: A Consumption-Based Explanation of Aggregate Stock Market Behavior," NBER Working Paper No. 4995, January 1995. See also M. Boldrin, L.J. Christiano, and J.D.M. Fisher, "Asset Pricing Lessons for Modeling Business Cycles," NBER Working Paper No. 5262, September 1995.

<sup>10</sup> J. Wang, "The Term Structure of Interest Rates in a Pure Exchange Economy with Heterogeneous Investors," NBER Working Paper No. 5172, July 1995.

<sup>11</sup> A. Shleifer and R.W. Vishny, "The Limits of Arbitrage," NBER Working Paper No. 5167, July 1995.

<sup>12</sup> B. LeBaron, "Technical Trading Rule Profitability and Foreign Exchange Intervention," NBER Working Paper No. 5505, March 1996.

<sup>13</sup> Y. Ait-Sahalia and A.W. Lo, "Nonparametric Estimation of State-Price Densities Implicit in Financial Asset Prices," NBER Working Paper No. 5351, November 1995. Ait-Sahalia has taken a similar nonparametric approach to interest-rate derivatives in "Nonparametric Pricing of Interest Rate Derivative Securities," NBER Working Paper No. 5345, November 1995.

<sup>14</sup> D.S. Bates, "Testing Option Pricing Models," NBER Working Paper No. 5129, May 1995, and "Post-'87 Crash Fears in S&P 500 Futures Options," NBER Working Paper No. 5894, January 1997.

<sup>15</sup> T.G. Andersen and T. Bollerslev, "Heterogeneous Information Arrivals and Return Volatility Dynamics: Uncovering the Long Run in High Frequency Returns," NBER Working Paper No. 5752, September 1996, and "DM-Dollar Volatility: Intraday Activity Patterns, Macroeconomic Announcements, and Longer Run Dependencies," NBER Working Paper No. 5783, October 1996.

<sup>16</sup> R.F. Engle and J.V. Rosenberg, "Hedging Options in a GARCH Environment: Testing the Term Structure of Stochastic Volatility Models," NBER Working Paper No. 4958, December 1994, and "GARCH Gamma," NBER Working Paper No. 5128, May 1995, and B. Dumas, J. Fleming, and R.E. Whaley, "Implied Volatility Functions: Empirical Tests," NBER Working Paper No. 5500, March 1996.

<sup>17</sup> R.F. Engle and J.R. Russell, "Forecasting Transaction Rates: The Autoregressive Conditional Duration Model," NBER Working Paper No. 4966, December 1994, and R.F. Engle, "The Econometrics of Ultra-High Frequency Data," NBER

Working Paper No. 5816, November 1996.

<sup>18</sup> The Industrial Organization and Regulation of the Securities Industry, A.W. Lo ed., Chicago: University of Chicago Press, 1996, contains several papers on this topic.

<sup>19</sup> K.K. Lewis, "What Can Explain the Apparent Lack of International Consumption Risk Sharing?," NBER Working Paper No. 5203, August 1995, and "Consumption, Stock Returns, and the Gains from International Risk Sharing," NBER Working Paper No. 5410, January 1996, explore some possible explanations for the home bias puzzle and compare alternative measures of the welfare cost of home bias. G. Bekaert and M.S. Urias, "Diversification, Integration, and Emerging Market Closed-End Funds," NBER Reprint No. 2066, September 1996, and Journal of Finance 51, 835-869, July 1996, shows how closed-end funds that hold shares in emerging markets can be used for international diversification.

<sup>20</sup> J.-K. Kang and R.M. Stulz, "Why Is There a Home Bias? An Analysis of Foreign Portfolio Equity Ownership in Japan," NBER Working Paper No. 5166, July 1995, and J.A. Frankel and S.L. Schmukler, "Country Fund Discounts,

Asymmetric Information, and the Mexican Crisis of 1994: Did Local Residents Turn Pessimistic Before International Investors?," NBER Working Paper No. 5714, August 1996.

<sup>21</sup> R.J. Shiller and S. Athanasoulis, "World Income Components: Measuring and Exploiting International Risk Sharing Opportunities," NBER Working Paper No. 5095, April 1995; R.J. Shiller and R. Schneider, "Labor Market Indices Designed for Use in Contracts Promoting Income Risk Management," NBER Working Paper No. 5254, September 1995; and R.J. Shiller and A.N. Weiss, "Home Equity Insurance," NBER Working Paper No. 4830, August 1994.

<sup>22</sup> J.Y. Campbell and R.J. Shiller, "A Scorecard for Indexed Government Debt," NBER Macroeconomics Annual 11, 155-197, 1996, and D.G. Barr and J.Y. Campbell, "Inflation, Real Interest Rates, and the Bond Market: A Study of UK Nominal and Index-Linked Government Bond Prices," NBER Working Paper No. 5821, November 1996.

<sup>23</sup> N. Canner, N.G. Mankiw, and D.N. Weil, "An Asset Allocation Puzzle," NBER Working Paper No. 4857, September 1994.

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## Research Summaries

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### Economic Analysis of Law

Lucian A. Bebchuk\*

My general interest is in using economics to analyze the effects of legal rules and institutions. In this article, I describe my current and recent work in the economics of four areas in which legal rules and institutions play a major role: corporate control and structure, bankruptcy, contracts, and litigation and settlement.

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\*Bebchuk is a research associate in the NBER's Program in Law and Economics and a professor at Harvard Law School. His profile appears later in this issue.

### Corporate Control and Structure

While much of my earlier work in corporate control focused on takeover bids for companies with dispersed shareholders, my more recent research has focused on companies in which there is a controlling shareholder. In many public companies — both in the United States and (even more so) in other countries — a significant number of shares are concentrated in the hands of a controlling shareholder.<sup>1</sup>

One part of my research has focused on the decisions of controllers about selling their control

blocks. In a recent article, I have shown that such decisions often might be distorted.<sup>2</sup> The efficiency costs produced by these distortions should be regarded as arising from having a controlling shareholder structure.

A central feature of the model of control transfers that I have developed is that controllers may differ from each other in two respects: their ability to manage and produce value; and their ability to capture private benefits of control. My analysis shows that, under the existing regime in the United States, inefficient transfers may take place; this will happen when the potential new controller

has less managerial ability but a sufficiently greater ability to capture private benefits than the previous controller. Also under the existing regime, some efficient transfers may not take place; this will happen if the potential new controller, although better able to manage the company, has a sufficiently lower ability to capture private benefits.

My analysis also examined control transfers under the equal opportunity rule that prevails in many other countries. Under this rule, minority shareholders are entitled to participate in the transaction on the same terms as the control seller. My analysis shows that adopting the equal opportunity rule would prevent all inefficient transfers, but also would prevent a wider range of efficient transfers. Finally, the analysis has identified conditions under which adding the equal opportunity rule would and would not be efficient overall; for example, adopting the equal opportunity rule would produce an efficiency loss overall if existing and new controllers draw their characteristics from the same distributions.

In a related paper, Jesse Fried and I study the decisions of controllers on whether to effect a freezeout.<sup>3</sup> In a corporate freezeout, which is allowed under U.S. rules, a controller can take the shares of the minority shareholders and provide them instead with consideration exceeding the value of those shares as appraised by the court. Our model shows that decisions on whether to effect a freezeout may be distorted, thus producing another efficiency cost arising from having a controlling shareholder structure. The analysis identifies conditions under which efficient freezeouts might not take place or inefficient freezeouts might take place. We use this model to analyze how alternative legal rules perform with respect to the objectives of facilitating efficient freezeouts and

discouraging inefficient ones.

These two projects take as given the existence of control blocks. Another part of my research examines the factors that determine the initial ownership structure. In joint work, Luigi Zingales and I<sup>4</sup> analyze the choice that initial owners make between retaining a complete ownership structure and creating a controlling shareholder structure by selling some shares to the public. We show that, in this choice, private and social optimality might diverge.

The source of this potential divergence is an externality. The initial choice of ownership structure will have important effects on both the initial shareholders and the potential future buyers of control. Since the IPO price will reflect the effects of the choice on the initial shareholders, the initial owner will internalize these effects fully. Since potential future buyers are not "at the table" at the time of the IPO, however, the initial owner will not take into account the effect of the ownership structure on them. Our analysis identifies three ways in which the initial choice of ownership structure can affect these future buyers.

Having identified a possible distortion, we turn to identifying conditions under which the distortion leads to excessive or suboptimal incidence of controlling shareholder structures. Our analysis has normative implications for the regulation of sale of control transactions and of public offerings of minority shares. Among its positive implications, our analysis suggests reasons for the substantial differences in the incidence of control blocks across different countries.

## **Bankruptcy**

Much of my initial work on bankruptcy concerns the ex post distribution of value in corporate bankruptcy. In a joint article, Howard

Chang and I develop a bargaining model that explains why, under the existing corporate reorganization regime, equityholders are able to obtain value even when the creditors are not paid in full.<sup>5</sup> This model can help to explain the empirical evidence about the commonality of such deviations from the absolute priority of debt over equity.

In another article, I put forward a proposal for dividing the reorganization pie in a way that would eliminate deviations from absolute priority.<sup>6</sup> Unlike the existing bargaining-based method for reorganizations, the method that I propose involves no bargaining, nor does it require that the value of the reorganized company be identified. Under this method, the participants in a reorganization would receive a set of options with respect to the securities of the reorganized company. These options can be designed so that, whatever the reorganization value, the participants ultimately will all receive the value to which they are entitled according to the absolute priority standard.

My proposed "options" method of corporate reorganization has received many and varied reactions. Some have endorsed it (Aghion, Hart, and Moore, for example, have used it as the basis for the distribution of the reorganization value in their proposal on corporate reorganizations<sup>7</sup>), while others have expressed various criticisms and concerns. To address the issues raised, I have been working on a follow-up project that will explore how the options approach can and should deal with the various problems that commentators have raised with respect to it.

In developing the options method, my premise has been, as that of much of the literature on bankruptcy reform, that it is desirable to distribute the bankruptcy value in accordance with the absolute priority

principle. The problem that I sought to solve was just how to produce such a distribution, given that the bankruptcy value is not verifiable by courts. But an important question that might be raised is what the desirable distribution is. Of course, in choosing the bankruptcy distribution, it is important to consider the ex ante effects of alternative distributions. Some of my recent work seeks to contribute to the understanding of these ex ante effects.

In a recent article, Jesse Fried and I<sup>8</sup> analyze the ex ante effects of providing secured claims with full bankruptcy priority over unsecured claims. We show that, contrary to the conventional wisdom, providing such full priority has certain undesirable ex ante effects. In particular, full priority of secured claims leads to excessive use of security interests, distorts the choice between security interests and covenants, and produces suboptimal precautions against tort liability, use of covenants, and monitoring by secured creditors. Accordingly, we have put forward alternative rules for partial priority of secured claims, and we have analyzed the efficiency costs and benefits involved in the adoption of a partial priority regime.

In two other working papers, I analyze some of the ex ante effects of providing debtholders with absolute priority over equityholders. In one, I show that deviations from such absolute priority of debt over equity might have an adverse effect on the moral hazard problem between debt and equity.<sup>9</sup> In particular, such deviations might increase the excessive incentive that equityholders have to prefer risky projects over safe ones, to make dividend distributions, and to engage in claim dilution by issuing extra debt.

In the second paper, Randy Picker and I analyze certain positive ex ante effects of deviations from the

absolute priority of debt over equity.<sup>10</sup> Such deviations might have a positive effect on those decisions by managers-owners that determine the extent to which a firm's managers have an advantage over others in operating the firm's assets. Without any such deviations, managers will entrench themselves by over-investment in assets that require their unique skills, and they also will under-invest in firm-specific human capital. Allowing ex post deviations from absolute priority decreases the severity of these two problems.

## Contracts

In contract law, my interest is in understanding how the rules can affect the various aspects of the contracting parties' behavior. In an article published several years ago, Steven Shavell and I showed that contractual rules might have an effect on informational transfer between the contracting parties.<sup>11</sup> In analyzing the optimal default rule in a contractual setting, models generally had taken the information held by the contracting parties to be given. However, as our model suggested (and as was suggested by Ayres and Gertner in an article published at the same time<sup>12</sup>), the choice of an appropriate default rule might lead to transfers of information between the contracting parties and thus might reduce informational asymmetries between them. Our model also has analyzed when inducing such informational transfers would and would not be socially optimal.

In a recent paper Omri Ben-Shahar and I<sup>13</sup> examine the effects of legal rules on pre-contractual reliance. During contractual negotiations, but before entering a contract, parties might make reliance expenditures — expenditures that would increase the surplus should a contract be made but would be wasted otherwise. In the absence of any pre-contractual

liability, parties' reliance will be socially suboptimal. The focus of our model is on analyzing whether and how rules could be designed to induce optimal reliance decisions. We also study the effects of the rules governing pre-contractual liability on parties' decisions whether to enter into contractual negotiations.

In another recent working paper Ivan P'ng and I<sup>14</sup> analyze the effect of remedies for breach in those cases in which breach is not deliberate (a situation that has already received comprehensive treatment) but rather inadvertent. We analyze the effects of alternative remedies on parties' decisions with respect to taking precautions against inadvertent breach and with respect to investment in reliance on contractual performance.

## Litigation and Settlement

About a decade ago, I participated in initiating game-theoretic analysis of litigation and settlement decisions. A large literature has grown since then, and my 1984 model of pre-trial bargaining under imperfect information has been used by many of the subsequent papers.<sup>15</sup> I have remained very interested in this area and am currently working on two subjects within it.

One subject is the credibility of threats to sue. In negative-expected-value (NEV) suits, the expected litigation costs exceed the expected judgment. While it is widely believed that plaintiffs with NEV suits are often able to get something from the defendant, the question is what enables such potential plaintiffs to have a credible threat and to succeed in extracting value.

One possible explanation for the success of such suits, which I advanced in an early article on the subject, is rooted in the existence of imperfect information on the defen-



dant's side.<sup>16</sup> My more recent work, however, has examined the numerous situations in which the plaintiff is known to have an NEV suit.<sup>17</sup> In an article published last year and in a subsequent paper, I developed a model that can explain why plaintiffs might have a credible threat in such situations.

My model is based on the recognition that litigation costs are generally not incurred all at once but rather over time, with bargaining possibly taking place at various points throughout the litigation process. This divisibility of the litigation process plays a critical strategic role. Indeed, I demonstrate that greater divisibility of litigation costs can never hurt — and may help — the plaintiff's strategic position. Because of this effect of divisibility, plaintiffs have credible threats in a much wider set of cases — including numerous small-stake cases — than has been suggested by the prior economic analysis of the subject.

My analysis also attempts to identify the conditions under which a plaintiff with an NEV suit will succeed in extracting a settlement. In particular, my work shows how the credibility of such threats is shaped both by the relative sizes of the parties' litigation costs and by the ways in which the parties' litigation costs are expected to be distributed over time.

Second, I am working on an analysis of the terms of settlement. Much of the literature on settlement has focused on the factors determining its likelihood. The likelihood of settlement is of interest to economists, of course, since it determines the extent to which the deadweight costs of litigation will be incurred. In analyzing the effect of the law on behavior, however, the terms of settlement are also of great importance. And some of my current research concerns how these terms are effected by various

procedural, institutional, and contractual arrangements.

In a recent paper, I analyze the effect of fee-shifting rules on the terms of settlement.<sup>18</sup> For each of the main fee-shifting rules, the analysis examines whether the rule will make settlement terms more favorable to the plaintiff or the defendant — and also whether the rule will move these terms closer to, or further away from, the expected judgment.

In another recent paper, Howard Chang and I model the effects of offer-of-settlement rules on the terms of settlement.<sup>19</sup> Under such rules, if a party to a lawsuit makes a formal offer to settle and the offer is rejected, then this offer will become part of the record in the case and the allocation of litigation costs will depend on how the judgment in the case compares with this offer. Our model makes it possible to derive the expected settlement amount under any given offer-of-settlement rule. Our analysis also shows how such a rule can be designed, if this is deemed desirable, to eliminate the bargaining disadvantage that a party with higher litigation costs would have otherwise.

Finally, in a recent article Andrew Guzman and I<sup>20</sup> analyze the strategic role that fee arrangements between lawyers and clients can play in settlement negotiations. Compared with an hourly fee arrangement, contingent fee arrangements strengthen the bargaining position of the side employing them, and thus make the terms of settlement more favorable to this party.

<sup>1</sup> See M. Barclay and C. Holderness, "Private Benefits from Control of Public Corporations," *Journal of Financial Economics* 25, (1989), pp. 371–95.

<sup>2</sup> See L. Bebchuk, "Efficient and Inefficient Sales of Corporate Control," *NBER Reprint No. 2012, October 1995, and Quarterly Journal of Economics* 109, (1994), pp. 957–93.

<sup>3</sup> See L. Bebchuk and J. Fried, "Efficient

and Inefficient Freezeouts of Minority Shareholders," mimeo, Harvard Law School (1997).

<sup>4</sup> See L. Bebchuk and L. Zingales, "Corporate Ownership Structures: Private versus Social Optimality," *NBER Working Paper No. 5584, May 1996*.

<sup>5</sup> See L. Bebchuk and H. Chang, "Bargaining and the Division of Value in Corporate Reorganization," *Journal of Law, Economics, and Organization* 8, (1992), pp. 253–79.

<sup>6</sup> See L. Bebchuk, "A New Approach to Corporate Reorganization," *Harvard Law Review* 101, (1988), pp. 775–804.

<sup>7</sup> See P. Aghion, O. Hart, and J. Moore, "The Economics of Bankruptcy Reform," *Journal of Law, Economics, and Organization* 8, (1992), pp. 523–546.

<sup>8</sup> See L. Bebchuk and J. Fried, "The Uneasy Case for the Priority of Secured Claims in Bankruptcy," *The Yale Law Journal* 105, (1996), pp. 857–934.

<sup>9</sup> See L. Bebchuk, "On the Effects of Deviations from Absolute Priority on Ex Ante Corporate Decisions," mimeo, Harvard Law School (1996).

<sup>10</sup> See L. Bebchuk and R. Picker, "Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital," forthcoming in the *Journal of Law and Economics*.

<sup>11</sup> See L. Bebchuk and S. Shavell, "Information and the Scope of Liability for Breach of Contract: The Rule of *Hadley v. Baxendale*," *Journal of Law, Economics, and Organization* 7, (1991), pp. 284–12.

<sup>12</sup> See I. Ayres and R. Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules," *Yale Law Journal* 99, (1989), pp. 87–130.

<sup>13</sup> See L. Bebchuk and O. Ben-Shahar, "Pre-Contractual Reliance," mimeo, Harvard Law School (1996).

<sup>14</sup> See L. Bebchuk and I. P'ng, "Damage Measures for Inadvertent Breach of Contract," mimeo, Harvard Law School (1996).

<sup>15</sup> See L. Bebchuk, "Litigation and Settlement under Imperfect Information," *Rand Journal of Economics* 15, (1984), pp. 404–15.

<sup>16</sup> See L. Bebchuk, "Suing Solely to Extract a Settlement Offer," *Journal of Legal Studies* 17, (1988), pp. 437–50.

<sup>17</sup> See L. Bebchuk, "A New Theory Concerning the Credibility and Success of Threats to Sue," *Journal of Legal Studies* 25, (1996), pp. 1–26; L. Bebchuk, "On Divisibility and Credibility: the Effects of

*the Distribution of Litigation Costs over Time on the Credibility of Threats to Sue,*" mimeo, Harvard Law School (1996).

<sup>18</sup> See L. Bebchuk, "The Effect of Fee-Shifting Rules on Settlement Terms," Har-

vard Law School, Discussion Paper No. 202 (1996).

<sup>19</sup> See L. Bebchuk and H. Chang, "The Effect-of-Settlement Rules on the Terms of Settlements," mimeo, Harvard Law

School (1997).

<sup>20</sup> See L. Bebchuk and A. Guzman, "How Would You Like to Pay for That?," Harvard Negotiation Law Review 1, (1996), pp.53-63.

## Sunk Investments, The Churn, and Macroeconomics

by Ricardo J. Caballero\*

Behind the smooth path of macroeconomic aggregates, there is a very active microeconomic world. Massive flows of factors of production constantly are being reshuffled, while households are busy rebalancing their stocks of durables, real estate, or even their lifestyles. Market economies seem to handle this overwhelming "churn" with undeniable success, and it follows therefore that the eventual failure of economies that repress private initiative is perhaps unavoidable.

Is the dynamic nature of microeconomic actions and heterogeneity just a distraction to macroeconomists, or does it hide an important piece of information about aggregate dynamics? In this article, I argue that there are at least two reasons to conclude the latter. The first of these reasons is very direct: The mechanics of aggregate fluctuations are quite different from those of representative agent models. The second reason is more involved: An active churn requires a massive flow of transactions, and associated with these, an ongoing process of contracting and renegotiation. In this highly demanding environment, contractual problems and malfunctioning institutions soon accumulate and affect macroeconomic outcomes, and they become a

major consideration for normative issues. For expositional simplicity, I discuss each of these themes in turn, although it should not be difficult to envision their close connection.

### Micro Adjustment is Intermittent and Lumpy

If one looks more closely inside the active microeconomic world, a distinctive intermittent pattern arises. At the level of individual units, there are many economically relevant actions which occur only infrequently and in lumps. For example, we do not upgrade our cars daily; rather we do it infrequently, and when we do so the improvement over our old car is substantial. Similarly, the intermittent and lumpy nature of investment and labor demand decisions at the establishment level has been documented extensively U.S. manufacturing.<sup>1</sup> Rather than the result of perfectly synchronized and smooth microeconomic actions, aggregate activity is driven largely by the net outcome of dramatic actions by a limited fraction of individual units. Aggregate fluctuations are influenced heavily by changes in the degree of synchronization of these sporadic but lumpy individual actions.

There are several technological and institutional reasons why microeconomic adjustment is largely intermittent and lumpy, the simplest of which is the presence of fixed costs of adjustment. Giuseppe Bertola and I start from a model in which consumers face such costs when adjust-

ing their stock of durable goods, and we then aggregate their lumpy actions, allowing for heterogeneous initial stocks of durables and idiosyncratic as well as aggregate shocks to their wealth. We show that such a model, albeit stylized, describes the quarterly behavior of purchases of U.S. durable consumer goods notably well. The estimated microeconomic adjustment costs and the degree of heterogeneity required to do so are reasonable.<sup>2</sup> Allowing for the same combination of ingredients — but with a (very small) fixed cost of adjusting consumption patterns — is also enough to account for the underreaction of aggregate non-durable consumption to wealth innovations (the excess smoothness puzzle) and its overreaction to predictable changes in income (the excess sensitivity puzzle).<sup>3</sup>

A significant fraction of plants' investment — and the bulk of the volatility of that investment — comes in sporadic large projects. Even with a sample biased toward large and stable U.S. manufacturing establishments, Doms and Dunne document that the majority of these establishments have years in which their capital grows by more than 50 percent.<sup>4</sup> Moreover, on average about 25 to 40 percent (in the 17-year period from 1972 to 1988) of the investment of an establishment is concentrated in one investment project.

My work with Eduardo M. Engel using annual U.S. manufacturing sectoral (aggregate) data shows that these data also could be explained well using a model built from microeconomic lumpiness and hetero-

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geneity.<sup>5</sup> Moreover, the statistical apparatus that we develop allows us to conclude that the model so constructed vastly outperforms the standard representative agent-linear competitors. The essence of the aggregate advantage of these models is their ability to generate brisker expansions and sharper contractions on the face of large — possibly accumulated — shocks.<sup>6</sup> The concept of pent-up demand acquires a very precise and useful meaning, where the aggregate elasticity of investment with respect to shocks changes over time, as accumulated shocks vary the degree of synchronization of establishments' actual and repressed investments. We not only confirm this conclusion in joint work with John C. Haltiwanger, but also are able to reconstruct all intermediate steps in the aggregation process. Using a panel of more than 7,000 U.S. manufacturing establishments for 1972 to 1988, we document the lumpy and largely irreversible nature of investment at the establishment level, the massive heterogeneity faced by establishments, and we show how the implied time varying elasticity plays a key role in shaping the response of aggregate investment to the tax reforms of the 1980s.<sup>7</sup>

Undoubtedly, investment imprints some of its features on employment and other complementary factors. However, decisions about job creation and destruction in U.S. manufacturing also exhibit a lumpy and intermittent pattern at higher frequencies than investment does. Using data similar to what we use for investment, we again document this microeconomic pattern, and show that the aggregated version of such a model clearly outperforms standard representative agent models in describing quarterly aggregate data (the latter had a mean-squared error about twice that of the nonlinear model). We trace the aggregate effect

of the microeconomic nonlinearities we find, and conclude not only that their impact is large, but also that it is concentrated during sharp recessions.<sup>8</sup>

## Job Creation and Destruction

This is a natural place to make the transition to the second theme of this review. In a series of papers, Mohamad Hammour and I study the ongoing process of job creation and destruction in detail. We ask positive as well as normative questions. If job reallocation is an inescapable requisite of technical progress and economic evolution, then policies that are overly protective of existing jobs may hinder the pace of renovation and lead to technological "sclerosis." But laissez-faire policies may be equally deficient. The massive job destruction that takes place in a recession, for example, may be the sign of chronically malfunctioning markets, rather than an aspect of the healthy recycling of jobs. Indeed, we argue that if the main role of unemployment in an efficient economy is to facilitate reallocation, then job destruction and creation ought to be synchronized and correlated positively, in order to avoid wasteful accumulation of persistent unemployment.<sup>9</sup>

This desirable feature is seldom observed. In the United States and other OECD countries, for example, job creation and destruction flows are correlated negatively.<sup>10</sup> More dramatically, economies undergoing deep structural adjustment generally are characterized by an existing productive structure that bears the full burden of the shock and faces extensive destruction, while the pace of creation and investment in the new structure remains excessively timid. This gives rise to a serious unemployment crisis, which not only

brings unnecessary suffering and waste but also puts at risk the political support for the much needed reforms.<sup>11</sup>

Many factors contribute to the widespread decoupling of creation and destruction flows. We argue, however, that harmful decoupling is the natural general equilibrium response to the presence of contracting difficulties at the microeconomic level.<sup>12</sup>

Most central economic relationships develop some degree of specificity among factors of production; that is, the value of those factors is higher within the relationship than outside it. Specificity reduces the flexibility of separation decisions, which induces reluctance in the investment decision. This is the basic insight of the irreversible investment literature, and a key ingredient in all of the models behind the results described in the first part of this review. However, it acquires a potentially more troublesome dimension when combined with contracting difficulties, for quasi-rents may not be divided ex-post according to their ex-ante terms of trade. This is the "holdup problem," which has been studied extensively in the microeconomics literature.

Rent appropriation, we argue, also has important macroeconomic implications. In general equilibrium, the market system will adjust to help partly compensate the appropriated factors, providing a highly inefficient macroeconomic "solution" to the unresolved microeconomic contracting problem. The appropriated factor of production will partially withdraw its participation in joint production, depressing creation. Excessive destruction, on the other hand, results from the rigid private opportunity cost of the appropriating factor, which in equilibrium will not find enough opportunities in joint production. Despite the resulting seg-

mentation of this factor, the rents earned in joint production are enough to put socially wasteful pressure on weaker production units.

The underutilization of resources and factor market segmentation just described are not the end of the story, though. Rent appropriation may also result in technological sclerosis, recessions that are excessively sharp, and expansions that run into inefficient bottlenecks. In the long run, institutions, such as those governing capital-labor relations, are likely to evolve to alleviate the harm of excessive appropriability problems; but the sluggish nature of institutional evolution is unlikely to keep up with the myriad economic events that alter the balance of forces. Technology choice also will be affected, with the appropriated factor partially "excluding" the other from production to reduce appropriation. In ongoing work, we are developing the hypothesis that long-run excessive technological substitution is an important ingredient in accounting for protracted European unemployment.<sup>13</sup>

The problem of appropriability affects many relationships and markets. Labor and financial markets are particularly hard hit. Firms need to invest in workers, who cannot credibly commit to fully repay these investments. Workers may have to renounce many opportunities in the process of specializing. Financiers are unable to precontract with managers on all future aspects of their project. The interaction between the inefficiencies in these markets is deeply intertwined with the nature of the churn. Problems in financial markets scramble the productivity-ranking of the Schumpeterian churn and lead to excessive turnover attributable to privately inefficient separations. When

combined with labor market problems, they raise unemployment, exacerbate aggregate volatility, and substantially increase the social cost of recessions.<sup>14</sup>

## Conclusion

To summarize, we cannot ignore the ebullient nature of the microeconomic world and the problems within it, if we are to give meaningful quantitative — and sometimes even qualitative — answers to questions as central as: What are the costs of recessions? How do financial and contractual factors hamper aggregate economic performance? What is the natural rate of unemployment? What is a "reasonable" level of job destruction and unemployment in the aftermath of structural adjustment?

Macroeconomists finally seem to be taking on this challenge; the "Non-representative agent" working group at the NBER's Summer Institute is oversubscribed and — more significantly — the group's name no longer differentiates its methods and themes from those discussed in several other EFG groups.

<sup>1</sup> M. Doms and T. Dunne, "An Investigation into Capital and Labor Adjustment at the Plant Level," mimeo, Center for Economic Studies, Census Bureau, 1993; D.S. Hamermesh, "Labor Demand and the Structure of Adjustment Costs," *American Economic Review* 79, 1989, pp. 674–89.

<sup>2</sup> G. Bertola and R.J. Caballero, "Kinked Adjustment Costs and Aggregate Dynamics," in NBER Macroeconomics Annual 1990, Cambridge: MIT Press (1990); R.J. Caballero, "Durable Goods: An Explanation for their Slow Adjustment," *Journal of Political Economy* 101 (2), April 1993, pp. 351–84.

<sup>3</sup> R.J. Caballero, "Near Rationality, Heterogeneity, and Aggregate Consumption," *Journal of Money, Credit and Banking* 27 (1), February 1995, pp. 29–48.

<sup>4</sup> Doms and Dunne, *op.cit.*

<sup>5</sup> R.J. Caballero and E.M.R.A. Engel, "Explaining Investment Dynamics in U.S. Manufacturing: A Generalized (S,s) Approach," NBER Working Paper No. 4887, October 1994.

<sup>6</sup> R.J. Caballero, "A Fallacy of Composition," *American Economic Review* 82 (5), December 1992, pp. 1279–92.

<sup>7</sup> R.J. Caballero, E.M.R.A. Engel, and J.C. Haltiwanger, "Plant Level Adjustment and Aggregate Investment Dynamics," *Brookings Papers on Economic Activity* 2, *Macroeconomics* 1995, 1–54.

<sup>8</sup> R.J. Caballero, E.M.R.A. Engel, and J.C. Haltiwanger, "Aggregate Employment Dynamics: Building from Microeconomics" forthcoming in *American Economic Review* 1997; R.J. Caballero, and E.M.R.A. Engel, "Microeconomic Adjustment Hazards and Aggregate Dynamics," *Quarterly Journal of Economics* 433 (2), May 1993, pp. 359–83.

<sup>9</sup> R.J. Caballero and M.L. Hammour, "On the Timing and Efficiency of Creative Destruction," *Quarterly Journal of Economics* 446 (3), August 1996, pp. 805–52; R.J. Caballero and M.L. Hammour, "The Cleansing Effect of Recessions," *American Economic Review* 84 (5), December 1994, pp. 1350–68.

<sup>10</sup> S.J. Davis, J.C. Haltiwanger, and S. Schuh, *Job Creation and Destruction*, MIT Press, 1996.

<sup>11</sup> R.J. Caballero and M.L. Hammour, "On the Ills of Adjustment," *Journal of Development Economics* 51, 1996, 161–192.

<sup>12</sup> R.J. Caballero and M.L. Hammour, "The 'Fundamental Transformation' in Macroeconomics," *American Economic Review, Papers and Proceedings* 86 (2), May 1996; R.J. Caballero and M.L. Hammour, "The Macroeconomics of Specificity," NBER Working Paper No. 5757, September 1996.

<sup>13</sup> R.J. Caballero and M.L. Hammour, "Incomplete Contracts, Factor Proportions, and Unemployment," mimeo, MIT, March 1997.

<sup>14</sup> R.J. Caballero and M.L. Hammour, "Improper Churn: Financial Constraints and Factor-Market Flows," mimeo, MIT, December 1996.

# Making Sense of the Medical System

David M. Cutler\*

Problems of the medical care system are among the most vexing issues on the public agenda. While virtually everyone complains about the medical care system, there is no general agreement about the diagnosis of what is wrong or the appropriate remedy. My research examines the performance of the medical care system and the role that the public sector can and does play in influencing that system.

Public complaints about the medical system are numerous.<sup>1</sup> About 15 percent of the United States population is without health insurance; in a rich country like ours, many find that unacceptable. Others who are insured find that coverage fleeting; they can get insurance when they are healthy but are canceled or face large rate increases when they become sick.<sup>2</sup>

But far and away the dominant concern about the medical care system is that it costs so much money. The United States spends nearly 14 percent of national income — close to one in every seven dollars — on medical care. Nearly 20 percent of government spending is for medical care. A person with an expensive illness can easily spend over \$100,000. The cost of medical care is so important because virtually every medical care problem we face — from caring for the uninsured to decisions by insurers to insure only the healthy — is made worse when medical costs are high. For example, some people are uninsured because the cost of insurance is so high compared to the

much smaller cost of receiving free care; if medical care were less expensive, this would be less of a concern. Similarly, insurers like to select healthy people to insure because the cost difference between healthy and sick is so great; if medical care were less expensive, the gains from favorable selection would be smaller.

Concern about high medical care costs is not unique to the United States. Throughout the developed world, the cost of medical care has increased in real, per capita terms twice as rapidly as national income for three decades or more.<sup>3</sup> As a result, medical care reform has been on the agenda of virtually every country in the OECD in recent years. Understanding the growth of medical care spending is thus a problem with world-wide implications. The first part of my research is thus focused on understanding the rising cost of medical care.

The passkey to access the medical care system is health insurance. Substantial evidence exists that people with health insurance receive more care, more frequently, from higher quality providers, in more appropriate settings, than do people without health insurance. Examining why people are without health insurance, and what role the public sector can plan in this issue, is the second part of my research.

## The Rising Cost of Medical Care

Very little has traditionally been known about the sources of cost increase in medical care. Public policy has generally focused on the price of medical services; deficit reduction, for example, is frequently accomplished by reducing the prices the government will pay for medical care over time.<sup>4</sup> But price increases need not be the whole story. Spend-

ing on medical care (or any good) can increase because prices are increasing (holding the quantity and quality of services constant) or because the quantity or quality of services is increasing.

In several recent papers, Mark McClellan and I have attempted to disentangle the sources of increased spending on medical care.<sup>5</sup> McClellan and I look in particular at spending on heart attacks. We use a case study approach because the only way to really understand the nature of medical care provision is to consider care for a particular condition. Heart attacks are a natural case study because they are quite common (there are roughly 250,000 new heart attacks annually in the Medicare population), they are very expensive (Medicare spending on hospital care for heart attack patients is over \$3 billion per year), and their costs are growing rapidly (over 4 percent per year in real, per capita terms). We use data on everyone in the Medicare program who had a heart attack between 1984 and 1991.

We decompose the growth of costs for heart attack patients into three factors: changes in the share of people who experience a heart attack; changes in the prices paid for a given level of treatment; and changes in the quantity of services provided to patients with a heart attack. We find that virtually all of the growth of medical care costs is a result of increases in the quantity of medical services provided. The incidence of heart attacks has been falling over time, as better diet, increased exercise, and medical therapies have improved cardiovascular health. The price of a given level of services has been essentially constant. What has been most important in explaining the rise of costs is the increasing intensity of medical treatments. In

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just the eight year period we study, the share of patients receiving very intensive diagnostic services (cardiac catheterization) rose from 11 to 40 percent, and the share receiving intensive therapeutic procedures (revascularization procedures such as bypass surgery or angioplasty) rose from 6 to 30 percent. Since more intensive care is reimbursed at a higher level than less intensive care, this increase in the intensity of services leads to substantial cost growth.

This conclusion naturally raises the question of why technology has diffused so rapidly. McClellan and I<sup>6</sup> posit six factors for the diffusion of medical technologies: organizational issues such as hospital size and ownership (for inpatient services); the generosity of insurance; public sector regulations on technology adoption; malpractice fears (“defensive medicine”); provider interactions such as the tendency of specialists to use more intensive procedures or of providers to compete with each other; and demographic factors such as age and income.

McClellan and I look at the importance of each of these factors in the diffusion of heart attack technologies. We find two factors to be of particular importance. The first is the generosity of insurance coverage. When insurance is more generous, technology diffuses more rapidly. The second factor is interactions among providers. When there are more providers in an area who are capable of using advanced technologies, these technologies are utilized more frequently.

These findings suggest that there are steps that public policy has taken and can take to influence the diffusion of technology. Tax policy and public regulations, for example, affect the generosity of insurance coverage. Policies towards the licensing of physicians will influence the physician distribution. In current

research, I am exploring how these and other policies have affected the dynamics of the medical care system.

## Is Technology Worth It?

In addition to understanding the sources of cost growth, we want to know if spending more on medical care is “worth it.” Spending more on medical care (or any good) is valuable if the services received have greater value than their cost. Spending more is wasteful if the services received are less valuable than their cost.

The value of medical care is its impact on the length and quality of life. Both of these factors are difficult to measure in aggregate, and to decompose into those portions due to medical care and those due to other factors. In research with Mark McClellan, Joe Newhouse, and Dahlia Remler, as well as research with Doug Staiger,<sup>7</sup> I have tried to measure the value of medical care using data on mortality from acute medical conditions (such as a heart attack).

In Cutler, McClellan, Newhouse, and Remler, we use Social Security death records for the patients in the heart attack sample that McClellan and I analyze, and measure changes in longevity for heart attack patients. Over the 1984 to 1991 period, life expectancy following a heart attack rose by about 8 months. If the value of a lifeyear is \$25,000 (a common estimate in the literature), the discounted value of this additional lifespan is \$15,000. In contrast, the real costs of treating a heart attack rose by only \$3,000. The implication is that the additional medical care provided more in the way of benefits than it cost — in other words, that it was worth it socially.

Staiger and I explore trends in outcomes for patients following an acute hospitalization between 1974 and 1987. Our sample includes patients

with a heart attack as well as a variety of other serious diseases such as congestive heart failure. Staiger and I find that mortality rates for acutely ill patients fell over this time period, but not by as much as for the heart attack sample. The increase in longevity appears to just match the increased cost of medical care. Staiger and I also find evidence that medical care appears to be overutilized. Over the time period that we examine, mortality rates in the few months after a hospitalization fell by much more than mortality rates one year after the hospitalization. Some of what medical care was buying was a postponement of death by several months, but not as long as a year.

This research suggests two important conclusions. First, the *average* value of medical care is very high. If one asks the question: for the average patient, have health outcomes improved to such a degree that the patient is better off now than he or she was a decade or two ago, even with the higher expenditures on medical care, the answer is generally yes. If one asks whether all of the people who receive a particular procedure or type of care benefit from it enough to justify its use, the answer is no. The *marginal* value of medical care appears to be very low.

One can understand these results using simple economic theory.<sup>8</sup> In the traditional medical care system, patients paid little for medical care at the time they used services and little for more generous insurance. As a result, there were incentives to develop beneficial — but expensive — new services and to provide them to all patients who would benefit at all, regardless of cost. Thus, people on average benefitted from medical care, but this technology would still be overused.

The medical system is currently transforming itself in a direction that might limit these developments.

"Managed care" is becoming the norm for the privately insured population. In this system, providers are not paid more to perform additional medical services; in some cases, they are even paid less if they provide more care. Patients are generally not free to go to the provider of their choice; typically, speciality care must be approved by a primary care gatekeeper in advance. And providers are monitored by insurers directly to limit the quantity of services they provide. These types of changes may have far-reaching consequences for the medical care system, and are a subject I am currently exploring.<sup>9</sup>

## Public and Private Insurance

There are two dominant sources of health insurance in the United States. Most of the population (close to two-thirds) has private health insurance. Generally, this is provided through an employer at substantial cost to the individual and his/her employer. A typical family policy, for example, might cost over \$5,000 per year. The second source of health insurance is the public sector. Medicare for the elderly and disabled, and Medicaid for the poor, elderly in nursing homes, and disabled, provide care to nearly 20 percent of the population. These programs are free or heavily subsidized, provided the person meets the eligibility criteria for the program.

The links between public and private insurance are multifaceted. On the one hand, public health insurance can provide access to care for those who would otherwise be without it; for many people, health insurance is simply too expensive to afford without government help. On the other hand, some people qualify for public insurance but have more substantial incomes. This is particularly true in recent years, when Medicaid has been expanded to cover a

greater array of people. In the mid-1980s, Medicaid was a program for poor single mothers and their children. Eligibility was tied to AFDC receipt, and encompassed only the very poor. By the early 1990s, Medicaid had been expanded to cover several other groups: single and married women with higher incomes who were pregnant; and children with higher incomes regardless of their family situation. These Medicaid expansions were the largest increase in public sector insurance since Medicare and Medicaid were established in 1965.

For people in these higher income groups, providing public insurance raises the potential problem of "crowding out": people might just substitute from private health insurance to public health insurance, without much overall increase in the amount of health insurance provided. This concern is particularly important in the Medicaid context; Jonathan Gruber and I<sup>10</sup> estimate that of the people newly covered by the expansions in the late 1980s and early 1990s program, two-thirds already had private health insurance. Analysis of crowding out has a long history in public economics — from Social Security to Aid to Families with Dependent Children — but crowding out has generally not been considered in the health insurance context.

Jonathan Gruber and I<sup>11</sup> have estimated the degree of crowding out empirically. Using cross-state and cross-age estimates, we look at how private insurance coverage responded to the Medicaid expansions of recent years. Gruber and I find substantial estimate of crowding out; for every 2 people who enrolled in Medicaid because of these coverage expansions, one person lost private insurance coverage.

Substitution of public for private insurance has good and bad points. On the negative side, it means that

society has to spend more than it wants to provide insurance to the previously uninsured. On the positive side, crowding out transfers income to a group (poor working families) that it has been traditionally hard to reach. Our research suggests that it is fundamentally important to consider the crowdout question as we design public policies for health insurance.

## Summary

My research on the medical sector leads me to two primary conclusions. First, we get a lot for our money. When we look at the outcomes of medical care for the average person the medical system provides a lot of value. But at the same time, the medical system has a lot of waste. Care gets provided that is not always worth its cost. People enroll in public insurance when we would rather have them be insured privately. These are pressing issues for the public sector, and how the public sector deals with them will have important implications for our satisfaction with the medical system in years to come.

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<sup>1</sup> For an overview of the medical care system, see D.M. Cutler, "A Guide to Health Care Reform," *Journal of Economic Perspectives* (Summer 1994), pp. 3-17; "Public Policy for Health Care," forthcoming in *Fiscal Policy: Lessons from Economic Research*, A. Auerbach, ed., 1997.

<sup>2</sup> D.M. Cutler, "Market Failure in Small Group Health Insurance," *NBER Working Paper No. 4879*, October 1994, discusses the evidence on this question.

<sup>3</sup> D.M. Cutler, "Does The United States Spend Too Much on Medical Care?" in *Health Care in the United States and Japan*, A. Garber, ed., forthcoming.

<sup>4</sup> D.M. Cutler, "Restructuring Medicare for the Future," in *Setting National Priorities*, R. Reischauer, ed., Washington, D.C.: The Brookings Institution, 1996, pp. 197-234.

<sup>5</sup> D.M. Cutler and M. McClellan, "What is Technological Change?" in *The Economics Of Aging*, D. Wise, ed., forthcoming;

D.M. Cutler and M. McClellan, "The Determinants of Technological Change in Heart Attack Treatments," NBER Working Paper No. 5751, August 1996.

<sup>6</sup> D.M. Cutler and M. McClellan, "The Determinants of Technological Change in Heart Attack Treatments."

<sup>7</sup> D.M. Cutler, M. McClellan, J.P. Newhouse, and D. Remler, "Are Medical Prices Declining?" NBER Working Paper No. 5750, September 1996; D.M. Cutler and D. Staiger, "Measuring the Benefits of Medical Progress," mimeo, September 1996.

<sup>8</sup> See Cutler and Staiger, *op. cit.*

<sup>9</sup> For discussion of these issues, see D.M. Cutler, "Restructuring Medicare for the Future," *op. cit.*; D.M. Cutler and S. Reber, "Paying for Health Insurance: The Trade-off Between Competition and Adverse Selection," NBER Working Paper No. 5796, October 1996; and D.M. Cutler, M. McClellan, and J. P. Newhouse, "Prices and Productivity in Managed Care Insurance," mimeo, March 1997.

<sup>10</sup> D.M. Cutler and J. Gruber, "The Effect of Medicaid Expansions on Public Insurance, Private Insurance, and Redistribu-

tion," *American Economic Review*, May 1996, pp. 378-383.

<sup>11</sup> D.M. Cutler and J. Gruber, "The Effect of Medicaid Expansions on Public Insurance, Private Insurance, and Redistribution;" D.M. Cutler and J. Gruber, "Does Public Insurance Crowd Out Private Insurance?," *Quarterly Journal of Economics*, May 1996, pp. 391-430; D.M. Cutler and J. Gruber, "Medicaid and Private Insurance: Evidence and Implications," *Health Affairs*, January/February 1997, 16 (1), pp. 194-200.

## Education, the Wage Structure, and Technological Change: Learning about the Present through the Past

Claudia Goldin\*

Lawrence F. Katz\*\*

### Human Capital Issues of Our Day

Rising income inequality and the possible causal roles of education and technological change are among the most prominent issues of our day. Earnings inequality has been rising since at least the late-1970s, as manifested in both the increased returns to education and the widening of the income distribution within groups. Many assert that high schools are failing to adequately train youths not bound for college and have serious shortcomings even for those who do continue their education. Employers today, it has been argued, pay little attention to secondary-school credentials, and youths not bound for college have scant incentive to excel

in school. In comparison with other countries and with what schools once accomplished, U.S. secondary education appears to be in decline. The decline, moreover, exists not because we are spending too little, but because, it is claimed, less is being bought for more.<sup>1</sup>

At the same time, the technologies of our day, particularly computer-based ones, are demanding more of workers. To many, the combination of the "dumbing down" of secondary schools and a technology that is ability-biased in its rewards have increased the returns to higher education, innate ability, and social background.<sup>2</sup> Public secondary schools, it is often asserted, respond poorly to incentives, and thus the situation will not improve until basic institutions are changed.

Other periods also have witnessed large advances in technology and increasing demands on the educational system. Did the wage structure widen with each wave of technological progress? And if technological change in the past increased the premium to skill, as it appears to be doing today, did U.S. educational institutions meet the challenges of technological booms? Immigration is a contentious issue today, in part

because of rising inequality. But immigration around the turn of this century was considerably greater and placed enormous strains on the nation's public-school resources. What was the public-sector's response during the period of mass European migration (1900 to 1914)? Rising inequality is a more serious issue today because productivity slowed beginning in 1973, and concern is often expressed that lagging U.S. productivity mirrors the increasing failures of its education system. How did educational advances of the past affect economic growth? Our joint and separate research over the past several years has addressed these questions and the related subjects of economic inequality, education, and technological change.

### The Rise of the American High School and Its Economic Consequences

Most of the increase (about 70 percent) in the educational attainment of Americans between 1900 and 1970 occurred at the secondary-school level and much of the advance was accomplished between 1910 and 1940, when the high-school gradua-

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tion rate rose from less than 10 percent to 50 percent. Because of the importance of the high-school expansion to educational change in the twentieth century, we began our project with an exploration of the rise of the American high school and the reasons for its extraordinary and unprecedented increase.<sup>3</sup> Our project is the first quantitative study tracking the expansion of secondary schooling in the United States and has produced a major panel data set of states (1910 to 1970s) and cities (1920s and 1930s).

Secondary (or preparatory) schools had existed in the United States, and much of Europe, well before their expansion in the early twentieth century, but they were institutions that primarily trained youths for college. In 1910, for example, half of public high-school graduates in the United States continued their education, a percentage that was higher than it would be until the 1970s. College enrollments after 1910 did not fall or even slow down in their rate of increase. Rather, youths began to enter high schools to obtain an education that would lead directly to employment, not college. The economy had begun producing white-collar jobs that demanded formal education in excess of that provided by the common schools but considerably less than that furnished by college. The public educational system responded by altering its curriculum. In 1900 more than half of all public high-school students enrolled in Latin classes and virtually none took commercial courses. By 1935 only about 15 percent studied Latin, whereas 10 percent enrolled in bookkeeping, 17 percent in typing, and 9 percent in shorthand. By the 1920s the blue-collar sector also was producing jobs that demanded far more education than that provided by grammar school. The educational system

responded here as well, by offering shop, chemistry, mechanical drawing, and other courses that endowed students with the cognitive skills demanded by employers.

The modern secondary school was virtually invented in America where it diffused more completely and rapidly than in Europe. Youths in most European countries would have to wait another 20 or 30 years for their "high school movement" to begin. Educational differences that had narrowed between parts of Europe and America in the late-nineteenth century emerged again in the early part of the twentieth century and grew substantially. By the 1950s youths in the United States were three decades ahead of their British counterparts in terms of high school enrollment and graduation rates.

High school attendance and graduation rates, although much higher in America than in Europe, diffused differentially across the United States. Our state-level data show that certain states underwent spectacular increases in secondary schooling from 1910 to the mid-1930s. Although the increase in secondary schools began in New England, its states were rapidly eclipsed by those in the Pacific and West North Central regions. Southern states, as well as those of the industrial North, lagged. California, Iowa, Kansas, and Nebraska were among the leaders in secondary education in the 1920s, whereas the northern laggards were states like New Jersey, New York, and Pennsylvania. The rates achieved in the leading states were so high by the mid-1930s that they were not again exceeded until the 1960s. The industrial North closed much of the gap during the Great Depression, when jobs for youths were scarce, and the South rapidly converged on the rest of the nation in the 1950s and 1960s.

Using our state- and city-level data we have begun to explore the reasons for the expansion of secondary schooling. Although there are too few countries to analyze the causes of differences between the United States and Europe, there are enough states and cities in the United States to analyze differences within that nation. In a recent paper, we use the cross-section and time-series variation for the United States to better understand the wide differences in schooling across nations.<sup>4</sup> We find that the factors that encouraged early expansion of secondary schools were high levels of income and wealth, a more even distribution of wealth, less manufacturing given income levels, and more state support to college education. States with a larger fraction of older inhabitants had higher, not lower, graduation rates, unlike findings using more recent data. We also find that state laws regarding compulsory education and child labor appear to have lagged, rather than led, educational advance. States, however, do appear to have hastened the spread of secondary schooling by legislating school-district fiscal responsibility.

Why the United States has recently begun to fall behind some countries in the quality of its education may be rooted, ironically, in the virtues that, early in the twentieth century, led to the expansion of high schools that were open to all, publicly funded and provided, and largely forgiving in their standards for advancement.

## **The Changing Returns to Education and the Evolving Wage Structure**

Much of the motivation for our exploration of educational change was to understand its relationship to changes in the wage structure. But

easily-accessible data concerning economic inequality are far more reliable after the early 1960s than before, and prior to 1940 there is no representative nation-wide sample of individual wages or earnings. The period before 1940 has remained a statistical dark-age in terms of the entire distribution of earnings or wages and the returns to education. We have begun the task of reconstructing the pre-1940 history of economic inequality and the returns to education with research on the earnings of ordinary white-collar workers from 1890 to 1940.<sup>5</sup> We are also currently engaged in a large-scale collection of the Iowa state census of 1915, the only U.S. state census before 1940 which contains information on education, earnings, immigrant status, and religion, among other variables.

The return to secondary-school education was high in 1940, the first year that census data allow its estimation. But was it even higher before? The enormous increase in secondary schooling during the "high school movement" would suggest that it was. To estimate changes in the returns to education during the expansion of secondary schooling, we construct the first wage series by sex for ordinary white-collar workers (clerks, bookkeepers, secretaries, typists, stenographers) during the 1890 to 1940 period. We find that the premium to high-school educated workers plummeted sometime between 1890 and the late 1920s, declining 30 to 40 percentage points most likely in the World War I period. Our best estimate of the rate of return to a year of high school for males was 22 percent before the decline and 12 percent after. We attribute much of the decline to the increased supply of high-school graduates during the initial period of the "high school movement" and far less to immigration restriction. But even

though the premium to education declined substantially, it remained relatively high until 1939 when it began to undergo another decline. The supply of educated workers expanded rapidly, but the demand for their skills, as we discuss below, also expanded. Thus even though the return to high school fell during the initial increase in secondary-school graduates, it remained relatively high until the 1940s.

The change in the return to schooling in the twentieth century is one part of the larger subject of changes in wage and income inequality. We have only just begun the more difficult task of mapping the full history of overall wage and income inequality in the United States across the past century. An extensive list of researchers has already done much of the pioneering work, but there are still large holes in the series particularly in the crucial period before the 1940s. Although we are now certain that there was a sharp decline in inequality in the 1940s, we have only scant evidence on what occurred before.<sup>6</sup> Simon Kuznets, using the income tax returns for the top portion of the income distribution, showed that the very top continued to gain at the expense of all others in the 1920s although the process began to reverse in the 1930s.<sup>7</sup> We are currently piecing together the various scraps of evidence, including those from our data project in-progress on Iowa, and are adding the data from our recent research to assess the past century's evolving wage structure.

### **The U.S. Educational Stock and Its Role in Economic Growth**

The 1940 census was the first at the federal level to inquire about the education of Americans, but the responses of older age groups have

been questioned for some time. To evaluate the suspect "stock" data on schooling levels from the 1940 census, we have constructed a new series built up from "flow" data on education contemporaneous with the period when the individuals were teenagers. Our findings are often vastly different from those derived from the 1940 census.<sup>8</sup> We have already subjected our series to numerous tests and checks that confirm the long-held suspicion that the 1940 and 1950 censuses vastly overstate the schooling of cohorts educated before 1920 and thus that twentieth-century educational advance was even greater than the census data suggest.

The increase in the U.S. educational stock was a major contributor to American economic growth across much of the twentieth century according to numerous estimates. The forces of educational advance that drove growth in the past are now themselves slowing down and the implication, for some, is that productivity in consequence has waned. Our goal is to provide new evidence on the educational stock for a period of one of its greatest increases, that from 1910 to 1950. Our preliminary work indicates that the increase in years of schooling was even more rapid than prior measures indicate. Thus, education's role in economic growth may have been larger than previously thought.

### **Technological Change and Technology-Skill Complementarity**

U.S. educational wage differentials have expanded over the past forty years despite continued and large increases in the relative numbers of more educated workers. The phenomenon strongly suggests that rapid increases in the demand for skilled

workers have on average outpaced the depressing effect of the increase in their supply. One popular explanation for secular shifts in relative labor demand favoring more skilled workers is that technological change has a strong "skill-biased" component. Another possibility is that physical capital is more complementary with human capital (skilled labor) than with raw (unskilled) labor. Since the physical capital stock has tended to grow at a faster rate than the labor force, capital-skill complementarity implies growth in the relative demand for educated labor. Much empirical research covering the post-World War II period supports the capital-skill and technology-skill complementarity hypotheses.

Current research raises the question of whether new technologies and physical capital were always more complementary with skilled than with unskilled labor. There are reasons to believe that capital-skill complementarity may be a twentieth-century phenomenon. Studies of nineteenth-century manufacturing suggest that physical capital was complementary with raw materials and that both substituted for skilled labor. Further, many have argued that industrialization (at least through the early twentieth century) served to "deskilled" a host of artisanal trades and reduce the relative earnings of craftsmen such as weavers, shoemakers, and puddlers. In recent research we demonstrate that capital and skill, and technology and skill, were strong complements by the 1910s and 1920s and that the complementarities were associated with particular technologies, such as continuous and batch processes as well as the adoption of electric motors.<sup>9</sup>

Even though it is often claimed that we are living in a period of unprecedented and extraordinary technological change, the advances that appeared or diffused in the two

decades around 1915 may have been more consequential. Manufacturing horsepower in the form of purchased electricity rose from 9 percent in 1909 to 53 percent in 1929; similar changes swept residential use. New goods proliferated, such as the automobile, airplane, commercial radio, aluminum, synthetic dyes, and rayon; household electric appliances such as the refrigerator and washing machine; office machinery such as calculators, dictating machines, and copying equipment. We demonstrate that many of these new processes and goods increased the relative demand for educated workers.

Using the 1940 census data, we show that the fraction of young (18 to 34 year old) male, blue-collar workers (operatives, craft, laborers) with high-school educations was far greater in the new high-tech industries of the day (for example, certain chemicals, scientific equipment, petroleum refining, radio, aircraft, telephone, and electrical and other machinery) than in the older standards of American industry. It was not just the burgeoning white-collar sector that increased the demand for high-school graduates. Managers in the manufacturing, transportation, and public utilities sectors valued those blue-collar workers who had cognitive skills enabling them to compute formulas, read blueprints, comprehend complex manuals, and understand the basics of chemistry and electricity, for example.

Many parallels exist between the impact of technological change today and in the past. We have already found that shifts in labor demand favoring skilled workers, between 1910 and 1930, are similar in magnitude to those more recently. But the wage structure changes accompanying these technologically-induced demand shifts have been different. The wage structure today has expanded far more than it did during

the previous era of great technological advance that we have explored. One possible reason for the different response in the wage structure is that the supply of educated workers rose far more in the past, an increase that resulted from the "high school movement."

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<sup>1</sup> On school expenditures see, for example, E.A. Hanushek, "Rationalizing School Spending: Efficiency, Equity, and Their Connection to Rising Costs," in *Individual and Social Responsibility*, V. Fuchs, ed. Chicago: University of Chicago Press, 1996; C.M. Hoxby, "Are Efficiency and Equity in School Finance Substitutes or Complements?," *Journal of Economic Perspectives* 10 (Fall 1996), pp. 51-72; on employers see J.H. Bishop, "Nerd Harassment, Incentives, School Priorities and Learning," unpublished paper, Cornell University, 1996.

<sup>2</sup> On computers and recent wage structure changes see, for example, D. Autor, L.F. Katz, and A.B. Krueger, "Computing Inequality: Have Computers Changed the Labor Market?" forthcoming as an NBER Working Paper.

<sup>3</sup> See C. Goldin, "How America Graduated from High School: 1910 to 1960," NBER Working Paper No. 4762, June 1994; "Appendix to: How America Graduated from High School: The Construction of State-Level Education Data," NBER Historical Working Paper No. 57, June 1994; "Egalitarianism and the Returns to Education during the Great Transformation of American Education," 1996, revised version of a paper presented at the Symposium on the Economic Analysis of Social Behavior, Chicago, IL; "America's Graduation from High School: The Evolution and Spread of Secondary Schooling in the United States," unpublished paper, Harvard University, 1996; and C. Goldin and L.F. Katz, "Why America Led in Education: Lessons from Secondary School Expansion, 1910 to 1940," forthcoming as an NBER Working Paper.

<sup>4</sup> C. Goldin and L.F. Katz, "Why America Led in Education: Lessons from Secondary School Expansion, 1910 to 1940," *op. cit.*

<sup>5</sup> C. Goldin and L.F. Katz, "The Decline of Noncompeting Groups: Changes in the Premium to Education, 1890 to 1940," NBER Working Paper No. 5202, August 1995.

<sup>6</sup> C. Goldin and R.A. Margo, "The Great Compression: The Wage Structure in the United States at Mid Century," *Quarterly Journal of Economics* 107 (February 1992), pp. 1-34.

<sup>7</sup> S. Kuznets, *Shares of Upper Income Groups in Income and Savings*, New

York: National Bureau of Economic Research, 1953.

<sup>8</sup> C. Goldin and L.F. Katz, "The U.S. Educational Stock and Economic Growth: New Estimates and Their Implications," *working paper in progress*.

<sup>9</sup> C. Goldin and L.F. Katz, "Technology, Skill, and the Wage Structure: Insights from the Past," *American Economic Review, Papers & Proceedings* 86 (May 1996), pp. 252-57; "The Origins of Technology-Skill Complementarity," NBER Working Paper No. 5657, July 1996.



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## NBER Profile: *Lucian A. Bebchuk*

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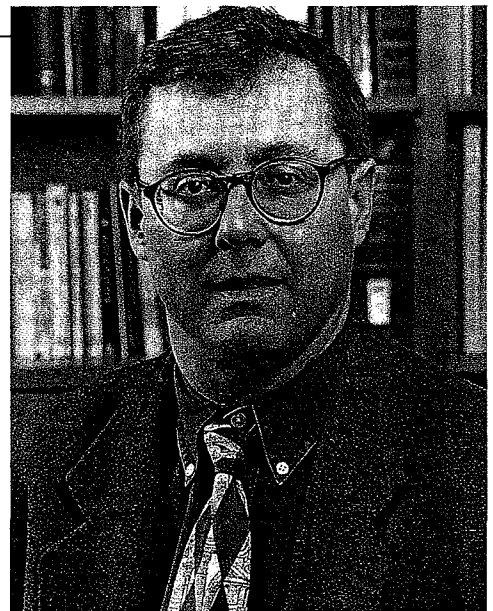
Lucian A. Bebchuk is a Professor of Law, Economics, and Finance at Harvard Law School, and a research associate of the National Bureau of Economic Research.

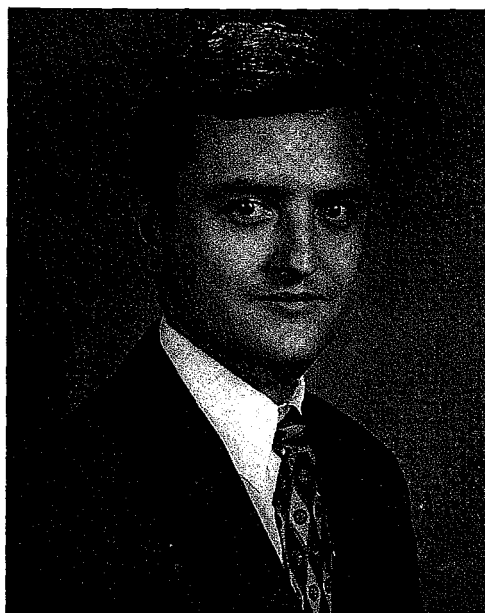
Bebchuk grew up in Israel, where he obtained a B.A. in mathematics and economics from the University of Haifa and an LL.B. from the University of Tel-Aviv. For his graduate work he went to Harvard, where he received an M.A. and a Ph.D. in economics from the Harvard Economics Department, and an LL.M. (Masters in Law) and an S.J.D. (a doctorate in law) from the Harvard Law School. During his graduate studies at Harvard, he was a Junior Fellow of the Harvard Society of Fellows between 1983 and 1985.

Bebchuk joined the Harvard Law School faculty in 1986 as an assistant professor, and he was promoted to full professor in 1988. He has visited the University of Chicago and also has been a frequent visitor to Tel-Aviv University. He is a member of the Board of Directors of the American Law and Economics Association and of the John M. Olin Center for Law, Economics, and Business at Harvard Law School.

Bebchuk's interests lie in the use of economics and finance to analyze the effects of legal rules and institutions. He has worked on a broad range of subjects and has published extensively in economic, financial, and legal journals. In the area of corporate structure and governance, he has worked on corporate takeovers, the contractual structure of firms, sale of control blocks, insider trading, corporate fiduciary duties, and state competition in corporate law. In bankruptcy, his research has examined corporate reorganizations, secured debt, and the ex ante effects of bankruptcy. In the area of litigation and settlement, his research has brought game theory to bear on decisions whether to sue and whether to settle. Finally, in the area of contracts, his research has focused on the effects of contractual rules on informational transfers as well as performance and reliance decisions.

Bebchuk and Alma Cohen, a doctoral student at Harvard, live in Cambridge, MA. To counter the potentially adverse effects of excessive work, they try to do some of their work in cafes.





## NBER Profile: *Ricardo J. Caballero*

Ricardo J. Caballero is an NBER research associate in economic fluctuations and growth and a professor of economics at MIT. Caballero, a Chilean native, received his B.S. and M.A. in economics from the Pontificia Universidad Catolica de Chile and his Ph.D. from MIT. From 1988 to 1992, he was an assistant and then an associate professor of economics at Columbia University. He spent 1991–2 at the NBER as an Olin Fellow, after which he stayed in Cambridge as the Castle-Krob Associate Professor of Economics at MIT. He was promoted to full professor in 1995.

Caballero's teaching and research fields are macroeconomics and international economics. His writings have been published in numerous profes-

sional journals and scholarly volumes: his current research looks at macroeconomic aspects of labor and capital markets. He also has written about aggregate consumption, exchange rates, externalities, growth, price rigidity, capital flows, and dynamic aggregation. He is an associate co-editor of the *Journal of Monetary Economics* and serves on the editorial board of *Cuadernos de Economia* and *Revista de Analisis Economico*.

Caballero also has been a visiting scholar and consultant at the International Monetary Fund, the Inter-American Development Bank, the Federal Reserve Board, and the World Bank. He and his wife, Maggie, live in Brookline (MA) with their two daughters, Camila (6) and Isabella (4).

## NBER Profile: *Lawrence F. Katz*

Lawrence F. Katz is a professor of economics at Harvard University and a research associate in the NBER's Programs in Labor Studies and Economic Fluctuations and Growth. He received his A.B. from the University of California, Berkeley and his Ph.D. in economics from MIT. Before coming to Harvard in 1986, Katz was on the faculty at the University of California, Berkeley. He also served as the Chief Economist of the U.S. Department of Labor from January 1993 to August 1994. Katz has been editor of the *Quarterly Journal of Economics* since 1990. He is also a fellow of the Econometric Society and a "Global Leader of Tomorrow" of the World Economic Forum.

Katz's primary research interests focus on issues in labor economics and the economics of social problems and income distribution. His work has covered a wide range of topics including: unemployment; the measurement and determinants of economic inequality;

the evolution of the U.S. wage structure; theories of wage determination; education and the labor market; the problems of disadvantaged youth; regional labor markets; the economics of immigration; the impact of international trade on the labor market; welfare reform; and the evaluation of the effects of social programs and labor market policies. Much of his current work is joint with Claudia Goldin and explores the historical origins of the recent widening of the U.S. wage structure and the rise of U.S. educational attainment over the past century. He also continues to study the roles of technological change, international trade, immigration, and labor market institutions in explaining recent increases in U.S. wage inequality and differences among advanced nations in changes in inequality and unemployment. He recently edited the NBER volume *Differences and Changes in Wage Structures* (with Richard Freeman, published by the University of Chicago



Press in 1995).

Katz shares a house in Cambridge, common research interests, and hobbies with Claudia Goldin. They recently travelled to South-Central Nebraska to witness one of the last great migrations: the return of half a million sandhill cranes to the Platte River.

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## NBER Profile: *Claudia Goldin*

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Claudia Goldin is professor of economics at Harvard University and director of the NBER's Program on the Development of the American Economy. Before coming to Harvard she was on the faculty of the University of Pennsylvania, Princeton University, and the University of Wisconsin. She has won many teaching awards and enjoys teaching undergraduate and graduate students at Harvard University.

In 1991 Goldin served as vice president of the American Economic Association, and she was vice president of the Economic History Association in 1989. From 1984 to 1988 she was editor of the *Journal of Economic History*, and she is currently on the editorial boards of the *Quarterly Journal of Economics*, *Explorations in Economic History*, and the *Review of Economics and Statistics*. She is a fellow of the Econometric Society and of the American Academy of Arts and Sciences.

Goldin received her B.A. from Cornell University and her Ph.D. from

the University of Chicago. Her research is in the general area of American economic history and has covered a wide range of topics, such as slavery, emancipation, the post-bellum South, the family, women in the economy, the economic impact of war, immigration, New Deal policies, inequality, and education. Most of her research interprets the "present through the lens of the past" and explores the origins of current issues of concern, such as the reasons for immigration restriction, the causes of increased female labor force participation, the impact of technological change on the wage structure, and the role of education in ameliorating inequality. She is the author and editor of several books, among them *Understanding the Gender Gap: An Economic History of American Women* (Oxford 1990) and *The Regulated Economy: A Historical Approach to Political Economy* (with G. Libecap; University of Chicago Press 1994). She is currently exploring the rise of public education in America, particularly the "high school movement" of the



1910 to 1940 period and its impact on inequality of earnings.

Goldin is an avid bird watcher, mountaineer, and all-round naturalist, and shares these passions with her companion of many years, Lawrence F. Katz, with whom she co-authors much of her research.

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## NBER Profile: *David M. Cutler*

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David M. Cutler is a faculty research fellow in the NBER's Programs in Aging, Health Care, Public Economics, and Productivity. He is also associate professor of economics at Harvard University. He received his B.A. in economics from Harvard in 1987 and his Ph.D. in economics from MIT in 1991.

In addition to his positions at Harvard and the NBER, Cutler served in 1993 as Senior Staff Economist at the Council of Economic Advisers and Director of the National Economic Council. Cutler was primarily involved in drafting the Clinton Administration's healthcare reform proposal. He also has served on several government advisory panels, including groups at

the National Institutes of Health and the Social Security Administration.

Cutler's research focuses on the economics of health care. Currently, he is examining the sources of cost growth in medical care, the productivity of the medical system, and the relationship between public provision of medical care and private insurance coverage. Cutler is also an associate editor of the *Journal of Health Economics*.

Cutler lives in Cambridge, where he enjoys ultimate frisbee, walks along the Charles River, and reading history.

## Conferences

### Ninth Annual IASE Held in Argentina

The ninth Annual NBER Inter-American Seminar on Economics sponsored jointly with the Universidad de San Andres this year took place in Buenos Aires on November 17-19. The organizers were Sebastian Edwards, NBER and University of California, Los Angeles, and Mariano Tommasi, Universidad de San Andres. After an opening session that included remarks from Roque Fernandez, the Economic Minister of Argentina, the following papers were discussed:

**Mauricio Cardenas**, Foundation for Higher Education and Development, "Colombian Savings: A Long View"

Discussant: Jorge Streb, CEMA

**Jonathan Skinner**, NBER and Dartmouth College, **Karen Dynan**, Federal Reserve Board, and **Stephen Zeldes**, NBER and Columbia University, "Do the Rich Save More?"

Discussant: Guillermo Mondino, Fundacion Mediterranea

**Andrew Samwick**, NBER and Dartmouth College, "Discount Rate Heterogeneity and Social Security Reform"

Discussant: George McCandless, Universidad de San Andres

**Aaron Tornell**, NBER and Harvard University, and **Philip Lane**, Columbia University, "Adjustment of Savings and the Current Account to Windfalls"

Discussant: Juan Pablo Nicolini, Universidad di Tella

**Alan Taylor**, NBER and Northwestern University, "Argentina and the World Capital Market: Saving, Investment, and International Capital Mobility in the Twentieth Century"

Discussant: Roberto Cortes Conde, Universidad de San Andres

**Joshua Aizenman**, NBER and Dartmouth College, and **Andrew Powell**, Banco Central de la Republica Argentina, "The Political Economy of Public Savings and the Role of Capital Mobility"

Discussant: Pablo Sanguinetti, Universidad di Tella

**Marcio G.P. Garcia** and **Alexandre Barcinski**, Pontificia Universidad Catolica do Rio, "Capital Flows to Brazil in the Nineties: Macroeconomic Aspects and the Effectiveness of Capital Controls"

Discussant: Carlos Zarazaga, Federal Reserve Bank of Dallas

**Fernando Navajas** and **Ricardo Lopez Murphy**, FIEL, "Domestic Savings, Public Savings, and Expenditure on Durables"

Discussant: Osvaldo Schenone, Universidad de San Andres

**Carmen Reinhardt**, University of Maryland, and **Ernesto Talvi**, Inter-American Development Bank, "Capital Flows and Saving in Latin America and Asia: a Reinterpretation"

Discussant: Frederico Sturzenegger, Universidad de San Andres

**Felipe Morande**, ILADES, "Savings in Chile: What Went Right?"

Discussant: Claudio Sapelli, Universidad Catolica de Chile

**Cardenas** analyzes the long-term determinants of savings in Colombia. He uses time-series data to investigate the collapse of private savings in that country after the launching of the market-oriented reforms of 1990. In particular, he analyzes the possible interaction between savings and real exchange rate behavior, labor legislation reform, and trade liberalization reform. Cardenas suggests that the sharp decline (in excess of 5 percent of GDP) in private savings after 1990 was merely a temporary reaction to structural changes. He also finds that public savings consti-

tute a fundamental determinant of aggregate savings, and argues that a major fiscal adjustment would have a positive effect on savings in the long run.

Using a number of new datasets, **Skinner** and his co-authors confirm that high income households save a larger fraction of their permanent income than lower income households do. Also, based on saving rates for households headed by individuals aged 70 to 80, they find some evidence of a modest positive correlation between money income and saving, although the patterns are not

as consistent as those for younger households. In sum, these preliminary results on the saving behavior of older households cast doubt on the traditional life cycle model modified to allow differences in time preference rates, differences in Social Security replacement rates, and so on.

As many countries consider the privatization of existing pay-as-you-go Social Security systems, the option to make participation in the new system voluntary may appeal to policymakers who need to obtain the political support of their workers. A

critical issue in determining the popularity of such a reform and its economic consequences is households' preferences for consumption. **Samwick** finds that an appropriate menu of reform plans can induce the voluntary buyout of 84 percent of existing payroll taxes at a cost to national saving of less than 0.25 percent.

**Tornell** and **Lane** point out that the structure of the fiscal process is critical in what happens to the current account. In countries in which there is strong control over the national budgetary process, pressures to increase spending in the wake of extra resources can be resisted successfully, and an improvement in the current account takes place. Conversely, if there is divided control over the fiscal process, then the voracity effect described in this paper is allowed to operate and a perverse outcome occurs.

**Taylor** considers integration in the world capital market between the economies of the core and periphery in the twentieth century. He focuses in particular on Argentina. He argues that understanding the changing relations in international capital markets offers important insights into the growth and development process, especially for the countries of the periphery. Moreover, studying the historical extent of market integration yields information about current relationships between capital-scarce economies, like Argentina, and the global capital market as a whole. The repercussions of economic reform and demographic change also are likely to have implications for future saving, investment, and international capital flows.

**Aizenman** and **Powell** explain public saving and public investment in economies where fiscal budgeting decisions are the outcome of a political process which involves many groups competing for scarce funds. They show that there is a strong bias

towards noncooperation among these groups (in other words, a collective action problem). If there is no strong center to impose the cooperative solution, then this problem manifests itself in a very low savings rate. In the extreme, current spending may be determined simply by current tax income and by access to capital. This explains why in the face of a boom, which may be known to be temporary, governments may not save but rather may borrow more to finance even higher levels of expenditure.

Since the last quarter of 1991, a very restrictive monetary policy in Brazil has resulted in probably the world's highest yield to fixed income investments. As a result, there were massive capital inflows to Brazil. The magnitude of those flows exacerbated two macroeconomic problems: an increase in the quasi-fiscal deficit caused by the interest payments on the debt used to sterilize the inflows and, after the Real Plan, the overvaluation of the currency. **García** and **Barcinski** describe and analyze the restrictions to capital inflows, as well as the main "financial engineering" strategies used to circumvent these restrictions. Given the advanced stage of Brazil's domestic financial markets — including a powerful derivatives market — the restrictions have not been effective in preventing the inflows of foreign capital. Given the little progress achieved so far in the fiscal side of the reforms, it is also doubtful that these restrictions have been effective in a broader sense, that of allowing the government to buy time to implement the essential structural reforms. By reducing the urgency of the politically costly structural reforms aimed at increasing domestic savings, capital inflows may have detrimental incentive effects on the governments' resolve to push forward the stabilization plan.

**Murphy** and **Navajas** show that when aspects related to public sav-

ings and consumer durables are measured explicitly, there is a considerable reduction in the recent cycle of savings in Argentina. Both public savings and investment are responsible for sharp changes in domestic savings between decades, while a great deal of the cycle in private savings is explained by decisions about consumer durables. An examination of the saving-investment correlation shows a drop over time in both the short-run correlation and the speed of correction of any difference between both aggregates. However, a gap between savings and investment in Argentina is not a long-term phenomenon. Finally, an intertemporal optimization response by economic agents to new economic conditions, as well as elements of exaggerated optimism and pessimism, might explain the sharp cycle in the consumer durables spending that is behind the corresponding cycle in private savings.

**Reinhart** and **Talvi** show that, when trend and cyclical components of domestic saving and capital flows are taken into account properly, Asia and Latin America do not differ in the short-run response of domestic saving to capital inflows. The main differences pertain to the long-run behavior of saving rates, which are driven by trends in demographics, per capita GDP, and other factors. The authors conjecture that if the greater vulnerability of Latin America to volatile capital flows is explained somehow by saving rates, then it must be related to saving levels, rather than to the way domestic saving rates respond to changes in international capital flows.

**Morande** uses time-series analysis to investigate the causes behind the climb of Chile's savings from 6 to 26 percent of GDP. He finds that Chile's savings responded to structural, demographic, and policy variables. In particular, his analysis strongly



suggests that Chile's social security reform — which replaced an insolvent pay-as-you-go system with a privately managed, capitalization regime — had an important positive effect on private savings. He also finds that although government and foreign savings crowd-out private savings, they do so in less than a one-to-one fashion.

After the presentation and discussion of these papers, Luis Servén of the World Bank presided over a wrap-up of the conference and a dis-

cussion of future related research. The final session was a panel discussion, chaired by Mariano Tommasi, with the following panel members: Sebastian Edward; Domingo Cavallo, Fundacion Mediterranea; Carlos Rodriguez, Ministerio de Economia; Martin Feldstein, NBER and Harvard University; and Miguel Angel Broda. The panel discussed issues related to economic reform and asked whether Latin America was about to become the next "miracle" region in the world economy. The panel also

addressed issues related to institutional development, fiscal adjustment, investment, and productivity growth. They concluded that although Latin America had made tremendous progress, the region still showed some signs of fragility, especially with respect to the relative weakness of local banks. As in previous years, it is expected that the conference proceedings will be published in a special edition of the *Journal of Development Economics*.

## Purchasing Power Parity Revisited

On December 20 and 21, the NBER, the Tokyo Center for Economic Research (TCER), and the Centre for Economic Policy Research (CEPR) in London jointly sponsored a conference in Tokyo on "Purchasing Power Parity (PPP) Revisited: the Exchange Rate and Price Movements, Theory and Evidence." The organizers were Takatoshi Ito, IMF (on leave from the NBER), Masahiro Kawai, University of Tokyo, and Kiminori Matsuyama, NBER and Northwestern University. The program was:

**Charles M. Engel**, NBER and University of Washington; **Michael Hendrickson**, University of Washington; and **John Rogers**, Federal Reserve System, "International, Intracontinental, and Intra-planetary PPP." Discussants: Kenichi Ohno, Saitama University, and Shigehiro Shiratsuka, Bank of Japan.

**Torben Andersen**, University of Aarhus and CEPR, "Exchange Rate Volatility, Nominal Rigidities, and Persistent Deviations from PPP." Discussants: Charles M. Engel, and Colin McKenzie, Osaka University.

**Masahiro Kawai** and **Hidetaka Ohara**, University of Tokyo, "Nonstationarity of Real Exchange Rates in the G7 Countries: Cointegrating Relations with Real Variables." Discussants: Colin McKenzie, and Shinji Takagi, Osaka University.

**Yoko Sazanami**, **Fukunari Kimura**, and **Hiroki Kawai**, Keio University and TCER, "Sectoral Price Movements under the Yen Appreciation." Discussants: Torben Andersen, and Kazuo Heda, University of Tokyo.

**Axel A. Weber**, Bonn University and CEPR, "Sources of Purchasing Power Disparities: Germany versus the United States and Japan." Discussants: Shinji Takagi, and Alan M. Taylor, NBER and Northwestern University.

Discussants: Shinji Takagi, and Alan M. Taylor, NBER and Northwestern University.

**Alan M. Taylor**, and **Maurice Obstfeld**, NBER and University of California, Berkeley, "Nonlinear Aspects of Goods-Market Arbitrage and Adjustment: Heckscher's Commodity Points Revisited." Discussants: Mitsuhiro Fukao, Bank of Japan, and Axel Weber.

**Shin-ichi Fukuda**, University of Tokyo and TCER, and **Takashi Kano**, Hitotsubashi University, "International Price Linkage within a Region: the Case of East Asia." Discussants: Kenichi Ohno, and Eiji Ogawa, Hitotsubashi University.

**Takatoshi Ito**, "The Long-Run PPP of the Yen." Discussants: Shin-ichi Fukuda, and Sachiko Kuroda, Bank of Japan.

**Engel, Hendrickson, and Rogers** propose a new method of using panel data to test for purchasing power parity. Their method allows relative prices to adjust at different speeds among locations; it takes into account the interdependence of shocks and real exchange rates; and,

the outcome of their test does not depend on the "base country." They apply the test to real exchange rates for consumer prices from September 1978 to September 1994 among eight cities: New York, Los Angeles, Toronto, Vancouver, Zurich, Geneva, Frankfurt and Cologne. They are

unable to reject the null of unit roots in real exchange rates.

**Andersen** shows how changes in nominal exchange rates can have real effects and induce persistence in the adjustment of real exchange rates. The key to nominal rigidities is an imperfection in the capital market,

implying that agents cannot hedge perfectly against consumption risk. As a consequence, nominal changes have real effects, both by affecting the ex post real purchasing power of savings and by affecting the ex ante incentives in labor supply. Andersen considers the consequences of exogenous changes in the nominal exchange rate in a two-sector small open economy with competitive product and labor markets.

If real shocks, instead of nominal shocks, are dominant in an economy, then real shocks and the real exchange rate are expected to move together. With this framework in mind, **Kawai** and **Ohara** show that the real exchange rate is cointegrated with other real economic variables among the G7 countries. The productivity variable does not appear to be important in the cointegrating equation, but the terms-of-trade ratio is.

Using Japanese price data, **Sazanami**, **Kimura**, and **Kawai** investigate how far the price movements of tradable goods deviate from the law of one price under currency appreciation. They also investigate the relationship between the globalization of firms' activities and export pass-through. They find that internal-external price differentials have expanded surprisingly for most of the products since 1985. Commodities whose price gaps expanded quite a bit often are associated with governmental regulations and restrictive private business practices that may not necessarily be designed to discriminate against imports but in fact limit their market penetration. Second, the

authors find that globalization of the activities of Japanese firms affects their pricing behavior. Specifically, the export pass-through rate seems to have an inverted-U-shape relationship with the degree of globalization.

Recent research in international macroeconomics has rediscovered the problem of purchasing power parity. **Weber** uses an extended version of a structural vector autoregressive model to identify the importance of various types of real shocks (labor supply, productivity, and aggregate demand) and nominal shocks (money demand and money supply). Based on the evidence, he doubts that those shocks which drive real exchange rates are truly aggregate demand disturbances.

**Obstfeld** and **Taylor** propose that analysis of purchasing power parity and the law of one price should explicitly take into account the possibility of "commodity points" — thresholds delineating a region of no central tendency among relative prices, possibly because of a lack of perfect arbitrage in the presence of transaction costs and uncertainty. They devise a method to identify commodity points. Their model performs well using post-1980 data, and yields estimates that appear quite reasonable: adjustment outside the thresholds might imply half-lives of price deviations measured in months rather than years, and the thresholds correspond to popular rough estimates on the order of magnitude of actual transport costs. The estimated commodity points appear to be positively related to objective measures

of market segmentation, notably nominal exchange rate volatility.

**Fukuda** and **Kano** investigate how "prices" in East Asian economies are correlated with those in Japan and the United States. The analysis is particularly noteworthy because East Asian economies are geographically close to Japan but their currencies have been tied more to the U.S. dollar. The authors analyze two different types of "prices": the overall price levels in terms of the same currency and the relative prices between different commodities. They demonstrate that the overall price levels in East Asian economies are related closely to those in the United States. However, the relative prices in East Asian economies, especially those in Taiwan and Korea, are correlated closely to those in Japan. The results are in marked contrast with the price correlations in other regions.

**Ito** examines the long-run behavior of the yen/dollar real exchange rate. He combines several series to compose a Japanese consumer price index, U.S. consumer price index, and the yen/dollar exchange rate from 1880 to 1995, in order to examine hypotheses related to purchasing power parity (PPP). He tentatively concludes that there is a long-run tendency for reversion to the PPP. However, he finds no evidence of high growth with real exchange rate appreciation in the prewar yen/dollar exchange rate.

These papers and their discussions will be published in a special edition of the *Journal of the Japanese and International Economies*.

## Mergers and Productivity

Steven N. Kaplan of the NBER and the University of Chicago's Graduate School of Business organized a Bureau study on the effects of mergers on productivity as part of the NBER's Project on "Productivity and Technological Change." The results of this project were presented at a conference on "Mergers and Productivity" which took place on January 16-18. The program was:

**Stacey Kole**, University of Rochester, and **Kenneth Lehn**, University of Pittsburgh,

"Workforce Integration and the Dissipation of Value in Mergers: The Case of USAir's Acquisition of Piedmont Aviation"

Discussants: Severin Borenstein, NBER and the University of California, Berkeley, and Mark Knez, University of Chicago

**Charles Calomiris**, NBER and Columbia University, and **Jason Karceski**, Columbia University, "Is

the Bank Merger Wave of the '90s Efficient? Lessons from Nine Case Studies"

Discussants: Christopher James, University of Florida, and Anil K. Kashyap, NBER and University of Chicago

**Jason Barro**, Harvard University, and **David M. Cutler**, NBER and Harvard University, "Consolidation in the Medical Care Marketplace: A Case Study from Massachusetts"

Discussants: Paul Healy, MIT, and Frank R. Lichtenberg, NBER and Columbia University

**Bronwyn H. Hall**, NBER and University of California, Berkeley, "Mergers and R and D Revisited"

Discussants: Adam B. Jaffe, NBER and Brandeis University, and Steven N. Kaplan

**William Long**, Business Performance Research Associates, and **David Ravenscraft**, University of North Carolina, "Paths to Creating

Value in Pharmaceutical Mergers"

Discussants: George Baker, Harvard University, and Robert Gertner, NBER and University of Chicago

**Steven N. Kaplan**, **Mark Mitchell**, University of Chicago, and **Karen Wruck**, Harvard University,

"A Clinical Exploration of Value Creation and Destruction in Acquisitions: Organization Design, Incentives, and Internal Capital Markets"

Discussants: G. William Schwert, NBER and University of Rochester, and Rene M. Stulz, NBER and Ohio State University

**Raghuram Rajan** and **Luigi Zingales**, NBER and University of Chicago, and **Paolo Volpin**, Harvard University, "The Eclipse of the U.S. Tire Industry"

Discussants: Michael C. Jensen, NBER and Harvard University, and Robert H. Porter, NBER and Northwestern University

**Kole** and **Lehn** observe that in 1987, USAir's acquisition of Piedmont Aviation was praised as a perfect match. The combination of two strong airlines with contiguous route structures surely would improve the utilization of aircraft, maintenance facilities, and crews. The more extensive route structure would appeal to both Piedmont and USAir frequent travelers. However, USAir stumbled in the implementation process, and its present cost structure bears the legacy of those missteps.

The U.S. banking system is undergoing dramatic consolidation. America's historical predilection for requiring local bank chartering, and limiting the powers of commercial banks, has given way to a new era of deregulation in which nationwide banks with broad powers have taken

over the industry, building themselves up largely via acquisitions. Is the current merger wave in American banking helping to promote efficiency by increasing the size and scope of banks, or is the bank merger wave driven by darker aspirations — the search for monopoly rents or the job security and personal perquisites of bank managers? **Calomiris** and **Karceski** argue that detailed case studies of some of the most recent merger transactions help to resolve some of these apparent inconsistencies, and are particularly useful in an industry like banking where rapid changes make even the recent past a poor guide to the future.

**Barro** and **Cutler** examine consolidation in the Massachusetts hospital market. They find that consolidation is driven primarily by a large decline

in the demand for hospital beds, resulting from increased enrollment in managed care, and technological changes. The drive to consolidate appears through three primary forces: consolidation for closure; consolidation for economies of scale; and consolidation for network creation.

Using a newly constructed dataset containing approximately 6,000 United States publicly traded manufacturing firms that existed at some time between 1976 and 1995, **Hall** reexamines a series of findings about the relationship between restructuring activity and R and D investment during the 1980s, extending them to 1995. Her dataset is essentially a universe of such firms. She finds that: 1) between 1980 and 1995, employment in these firms fell from approximately 18 million to 13 million employees,

with most of the decline taking place by 1990. 2) This shrinkage was achieved by internal shrinkage in the sectors associated with the rust belt (such as primary metals and automobiles) and by exit (often via leveraged restructuring or going private) in the low- to medium technology sectors. The high technology sectors (pharmaceuticals, computing equipment, and the like) did not experience employment reductions. 3) Prior to 1987, firms that exited by going private had a substantially lower R and D-to-sales ratio than other firms, but after that date, there is only a small difference in R and D intensities between those who go private and the others. 4) Contrary to earlier findings that R and D was unchanged by mergers between two publicly traded firms during the 1980s, there is a slight hint that R and D may have declined after merger in the 1990s, although the result is not significant.

Since 1994, merger activity has been at an all time high. A critical component of this wave is the combination of large firms in industries like banking, health care, chemicals, defense, and utilities. **Long** and **Ravenscraft** attempt to gain insights into the causes and motivations of these large horizontal combinations through a detailed study of pharmaceutical mergers and, in particular, Glaxo's 1995 hostile takeover of Wellcome. Two characteristics — cross-border transactions and large horizontal deals — explain most of the value creation in pharmaceuticals, they find. Glaxo and Wellcome were driven to merging, because of the industry pressures and the fact that they were particularly hard hit because of the patent expiration of both of their major products. Their

merger allowed them to create value through \$1 billion in cost savings involving all functional areas: administrative, commercial, manufacturing, and R and D. A detailed look at these cost cuttings suggests that economies of scale and scope play a role, but the primary factor was excess capacity created by the reduced growth opportunities in the industry and the firm.

**Kaplan, Mitchell, and Wruck** present clinically-based studies of two acquisitions that received very different stock market reactions at announcement, one positive and one negative. Despite the differing market reactions, they find that, ultimately, neither acquisition created value overall. In exploring the reasons for these outcomes, they rely primarily on interviews with managers and on internally generated performance data. They compare the results of these analyses to those from analyses of post-acquisition operating and stock price performance traditionally applied to large samples, and draw three primary conclusions: 1) The findings highlight the difficulty of implementing a successful acquisition strategy and of running an effective internal capital market. Post-acquisition difficulties resulted because managers of the acquiring company did not study or understand the target company sufficiently at the time of the acquisition; the acquirer imposed an inappropriate organizational design on the target as part of the post-acquisition integration process; and inappropriate management incentives existed at both the top management and division level. 2) Measures of operating performance used in large sample studies often are correlated weakly with actual post-acquisition operating

performance. 3) The initial stock-market reactions to the acquisitions appear to have been reasonable.

**Rajan, Volpin, and Zingales** undertake an in-depth analysis of the tire industry during 1970–90. They attempt to uncover the causes and consequences of the acquisition activity in the industry in the 1980s, which resulted in all but one large U.S. tire manufacturer being sold to foreign companies. They do not find that ownership was acquired by more efficient producers. Nor were the takeovers undertaken in response to the failure of internal control systems to induce downsizing. The most likely explanation is that the acquisitions were driven by an increase in cross-border production and trade by automobile manufacturers. This increased the need for cross-border production by the tire manufacturers, as well as increasing the scale of product development and marketing required. U.S. manufacturers were preoccupied in the 1970s with the switch to radial tires, which the rest of the developed world had accomplished a decade earlier. In order to focus on the competitive domestic market and make the extraordinary investment required to switch to radials, they largely abandoned their international operations. This left them ill-equipped to realize the economies of cross-border production in the 1980s. As a result, all the major U.S. tire manufacturers with the exception of Goodyear were acquired by foreign firms in the 1980s.

The papers and discussions from this conference will be published in an NBER volume by the University of Chicago Press. Its availability will be announced in a future issue of the *NBER Reporter*.

## The Effects of Consumption Tax Reform

On January 27, the NBER held its first videoconference, linking researchers on the east and west coasts for a day-long meeting. The subject of this videoconference was "Asset Price and Transition Effects of Consumption Tax Reform." James M. Poterba, director of the NBER's Program in Public Economics and a professor at MIT, organized this program.

**David F. Bradford**, NBER and Princeton University, "Tax Rate

Flexibility in Consumption Tax Systems.

Discussant: **Michael J. Boskin**, NBER and Stanford University.

**William Gentry** and **R. Glenn Hubbard**, NBER and Columbia University, "Fundamental Tax Reform and Corporate Finance.

Discussant: **Robert E. Hall**, NBER and Stanford University.

**Andrew Lyon**, University of Maryland, and **Chris Edwards**, **Peter Merrill**, and **Mel Schwarz**,

Price Waterhouse, "Business Transition Issues in Fundamental Tax Reform."

Discussant: **James R. Hines, Jr.**, NBER and Harvard University.

**Martin S. Feldstein**, NBER and Harvard University, "The Effect of a Consumption Tax on the Rate of Interest."

Discussant: **Alan J. Auerbach**, NBER and University of California, Berkeley.

**Bradford** considers the design of rules that render consumption taxes immune to the incentive and incidence effects of changes in the rate of tax. He suggests that the issue arises mainly in the case of business cash-flow taxes, and shows that two relatively simple approaches are available to deal with it: grandfathering the tax rate applicable to a given period's investment or substituting depreciation allowances for the usual expensing of investment, coupled with a credit for the equivalent of interest on the undepreciated investment stock. One cost of this approach is its requirement of identifying true depreciation. Bradford takes up the risk-free case only; he is currently studying the considerations introduced by risk.

**Gentry** and **Hubbard** evaluate consequences of tax reform on corporate finance to distinguish between the effects of income tax reform and consumption tax reform. They focus on one fundamental income tax reform proposal — the Treasury Department's Comprehensive Business Income Tax (CBIT) — and one consumption tax reform proposal, the Flat Tax. They conclude that:

1) Relative to CBIT, the Flat Tax exempts only the risk-free return to capital. 2) The effect of fundamental tax reform on interest rates depends on whether dividend taxes are capitalized in share values and on the elasticity of the supply of funds to the domestic business sector with respect to the net return. 3) The effects of tax reform on organization and financing decisions stem from income tax reform, although the Flat Tax permits simpler rules for mergers and acquisitions than CBIT. 4) With regard to financial innovation for tax planning, to the extent that such innovations arise to muddle the distinction between debt and equity for tax purposes, they are no longer necessary under either CBIT or the Flat Tax.

**Lyon** and his co-authors examine transition issues that would arise for businesses as a result of replacing the income tax with a consumption tax. They quantify asset price effects for a variety of different types of property, under alternative assumptions about the way in which relative prices might adjust during the transition period. They also assess the size of the transition "problem" by estimating the impact of transition to a con-

sumption-based tax on the financial statement for 12 different industries. The authors also evaluate the extent to which wealth effects are mitigated by two options for allowing the deduction of unrecovered basis in assets acquired prior to tax reform.

**Feldstein** analyzes the ways in which substituting a consumption tax for the existing personal and corporate income taxes would affect equilibrium pretax interest rates. His analysis indicates that whether the pretax rate of interest rises or falls depends on the strength of the personal saving response, the nature of the capital market equilibrium between debt and equity yields, and the response of the owner-occupied housing sector. Further, his analysis suggests that the shift from an income tax to a consumption tax is more likely to raise rates than to lower them.

Also participating in this teleconference were: B. Douglas Bernheim, NBER and Stanford University; Daniel R. Feenberg and Andrew Mitrusi, NBER; Michael Graetz, Yale University; Laurence J. Kotlikoff, NBER and Boston University; and Gilbert E. Metcalf, NBER and Tufts University.

## The Costs and Benefits of Achieving Price Stability

Bureau President Martin Feldstein, also of Harvard University, organized an NBER project on the costs and benefits of reducing inflation from the current low rates in the United States and Western Europe to complete price stability. The project was an extension of an earlier study by Feldstein which was done as part of the NBER Project on Inflation organized by Christina and David Romer and published as *Reducing Inflation: Motivation and Strategy*.

In the earlier study, Feldstein showed that the interaction of tax rules and inflation causes a permanent loss of real income (that is, a deadweight loss) equal to 1 percent of GDP when the inflation rate is 2 percent rather than zero. The present value of having the zero inflation rate therefore exceeds substantially the estimated short-run cost of achieving the reduction. The purpose of the present project was to extend the earlier analysis in a variety of ways, to apply it to other industrial countries, and to examine other potential costs and benefits associated with low rates of inflation.

Participants in the project met with other economists for an NBER conference held at the Federal Reserve Bank of New York on February 20–21. Feldstein's paper for this conference, which was discussed by Stanley Fischer of the IMF (on leave from the NBER), repeated the earlier analysis with a few modifications and discussed some issues about the specification of the problem that had been raised since the earlier research was presented.

Then **R. Glenn Hubbard**, NBER and Columbia University, and **Kevin A. Hassett** and **Darrel Cohen**, Federal Reserve System, extend the analysis to deal with distortions in corporate finance. In "Inflation and the User Cost of Capital: Does Infla-

tion Still Matter?", discussed by Alan J. Auerbach of NBER and University of California, Berkeley, they demonstrate that the net effect of changes in the tax code and the level of inflation and investment since the 1970s has not relegated inflation to the sidelines. They conclude instead that: 1) inflation, even at its relatively low current rates, continues to increase the user cost of capital significantly; 2) the marginal gain to a percentage point reduction in inflation is larger for lower levels of inflation; 3) the beneficial effects of lowering inflation even further than has been achieved to date would likely be significant; and 4) inflation has only a small impact on intratemporal distortions in the choice of investment technology. They also analyze the effect of inflation on the user cost of capital in open economies.

**Mihir Desai**, Harvard University, and **James R. Hines, Jr.**, NBER and Harvard University, then extend Feldstein's analysis to the international economy. In "The Tax-Inflation Interaction in Open Economies," discussed by Jeffrey A. Frankel, Council of Economic Advisers (on leave from NBER), they estimate the efficiency costs of interactions between inflation and taxation in open economies. In a world of perfectly mobile portfolio capital flows, domestic inflation stimulates international capital movement, affecting domestic and foreign interest rates, tax receipts, saving behavior, and investment decisions. The efficiency costs associated with these inflation-induced international capital reallocations are typically much larger than those generated by the effects of inflation in closed economies. Domestic inflation has more moderate effects on interest rates, but potentially even more severe consequences for efficiency, in settings characterized by imperfect

international capital mobility, they conclude.

The Feldstein analysis — basically, what happens if we reduce inflation from current levels to roughly zero — was repeated by various authors for the economies of Spain, Germany, and Great Britain. These papers were discussed by Rudiger Dornbusch of the NBER and MIT and Andrew Abel of the NBER and University of Pennsylvania.

The Spanish case study, "A Cost-Benefit Analysis of Going from Low Inflation to Price Stability in Spain," was prepared by **Juan J. Dolado**, Universidad Carlos III, **Jose M. Gonzalez-Paramo**, Universidad Complutense, and **Jose Vinals**, Banco de Espana. They find the effect on Spanish GDP to be similar to what Feldstein found for the United States.

The German study, "Price Stability versus Low Inflation in Germany: An Analysis of Costs and Benefits," was undertaken by Deutsche Bundesbank economists **Karl-Heinz Todter** and **Gerhard Ziebarth**. They estimate that "the change of regime from an equilibrium inflation rate of 2 percent to a rate of zero brings permanent welfare gains, which have an equivalent value of 1.4 percent of GDP from year to year."

The U.K. analysis, "Some Costs and Benefits of Price Stability in the United Kingdom," was done by Bank of England economists **Hasan Bakshi**, **Andrew Haldane**, and **Neal Hatch**. They conclude that "aggregate welfare gains in the U.K. are much smaller than those of Feldstein for the U.S. — perhaps around one quarter of the size."

Two other papers deal with the more general effects of reducing a low inflation rate. "Inflation's Grease and Sand Effects in the Labor Market" by **Erica L. Groshen**, Federal

Reserve Bank of New York, and **Mark E. Schweitzer**, Federal Reserve Bank of Cleveland, discussed at the conference by Laurence M. Ball of NBER and Princeton University, explains that inflation has been accused of causing distortionary price and wage fluctuations (sand) as well as lauded for facilitating adjustments (grease) to shocks when wages are rigid downwards. The authors investigate whether these two effects can be distinguished from each other in a labor market by the following identifying assumption: Inflation-induced deviations among employers' mean wage-changes represent unintended intramarket distortions, while inflation-induced interoccupational wage-change dispersion reflects intended alignments with intermarket forces. The authors also look for evidence that recent years have seen an increase in the pace of occupational wage adjustment that is higher than historical patterns would predict, suggesting a rise in wage flexibility. Using a unique 40-year panel of wage changes made by large Midwestern employers, they find a wide variety of evidence to support the identifying assumption. They also find some indication that large firms may be gaining wage flexibility in the

past four years. These results lend strong support to findings that both grease and sand exist, but that they counteract each other in a welfare sense. Thus in the range between zero and 5 percent, the net impact of inflation is positive but statistically indistinguishable from zero, and it turns negative at rates over 5 percent. When positive, net benefits never exceed a tenth of gross benefits, though.

In "Does Inflation Harm Economic Growth? Evidence for the OECD," which was discussed by Federal Reserve Bank of New York Director of Research Frederic S. Mishkin (who is on leave from NBER), Bank of Spain economists **Javier Andres** and **Ignacio Hernando** conclude that even low or moderate inflation rates (as have occurred within the OECD) have a negative temporary impact upon long-term growth rates. This effect is significant and generates a permanent reduction in the level of per capita income. Inflation not only reduces the level of investment but also the efficiency with which productive factors are used. The estimated benefit of a permanent reduction in the inflation rate by a percentage point is an increase in the steady-state level of per capita in-

come which ranges from 0.5 percent to 2 percent. Although the size varies somewhat across specifications (as well as across different levels of inflation), the correlation among inflation and future income is never positive.

In addition to the authors and discussants already mentioned, some closing comments to the conference were made by Federal Reserve Governor Laurence Meyer, Benjamin Friedman of the NBER and Harvard University, and Martin Feldstein. Federal Reserve Bank of New York President **William McDonough** was the group's dinner speaker. Also participating in the discussions were: Phillip Cagan and Edmund Phelps, Columbia University; Stephen G. Cecchetti, NBER and Ohio State University; Douglas Elmendorf, Federal Reserve System; Matthew D. Shapiro, NBER and University of Michigan; and Anna J. Schwartz, NBER.

The papers and discussions presented at the conference, and a summary of the general discussion prepared by Erzo Luttmer of Harvard University, will be published by the University of Chicago Press in an NBER conference volume. Its availability will be announced in an upcoming issue of the *NBER Reporter*.



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## Bureau News

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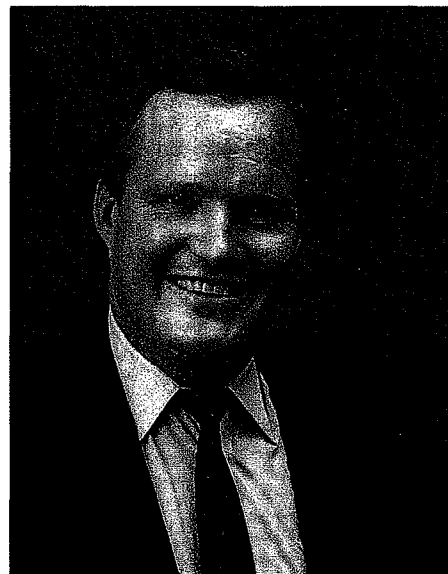
### Murphy to Receive Clark Medal

The 1997 John Bates Clark Award of the American Economic Association will be given to NBER Research Associate Kevin M. Murphy of the University of Chicago. Murphy was honored for his work on wages, wage inequality, and the relationship between wages and labor force participation.

Murphy has been a member of the NBER's Program in Labor Studies since 1985. He holds a bachelor's degree from the University of California, Los Angeles, and a Ph.D. from the University of Chicago.

The Clark Medal is awarded every

other year to the economist under the age of 40 who is judged to have made the most significant contribution to economics. Past recipients of the John Bates Clark Award who have been associated with the NBER are: Milton Friedman, 1951; Zvi Griliches, 1965; Gary S. Becker, 1967; Daniel McFadden, 1975; Martin Feldstein, 1977; Joseph E. Stiglitz, 1979; A. Michael Spence, 1981; James J. Heckman, 1983; Jerry A. Hausman, 1985; Sanford J. Grossman, 1987; Paul R. Krugman, 1991; Lawrence H. Summers, 1993; and David Card, 1995.



### Gruber and Scholz to Treasury

NBER Faculty Research Fellows Jonathan Gruber and J. Karl Scholz will both assume policy positions at the U.S. Department of the Treasury. Gruber, who teaches at MIT and is a member of the NBER's Programs on

the Well-Being of Children, Public Economics, and Health Care, will become Deputy Assistant Secretary for Economics on May 1. Scholz, who teaches at the University of Wisconsin and is a member of the Bureau's

Program on Public Economics, became Deputy Assistant Secretary for Tax Policy on January 21. Both will be on leave from the NBER during their stays in Washington.

### NBER Announces Nonprofit Fellowships

The NBER has awarded dissertation fellowships on "The Economics of the Nonprofit Sector" to Patrick Bayer of Stanford University, Mark Duggan of Harvard University, and Jeffrey Kling of MIT. As part of a new program designed to encourage research on nonprofit institutions by NBER research associates and faculty research fellows, and to support dissertation research on the same subject by graduate students in economics who work closely with them, small grants were also awarded to NBER researchers Martin Gaynor of

Carnegie Mellon University, James J. Heckman of the University of Chicago, Michael Kremer of MIT, and Naci H. Mocan of University of Colorado, Denver. The Bureau expects to make additional awards next year.

Bayer plans to study "Competition Between Public and Private Schools." Duggan will look at "Decisionmaking in Nonprofit Hospitals," considering both administrative and care-related decisions. Kling will examine "the role of nonprofit organizations in helping families move out of public housing" and into apartments found

on the private market — this type of program becomes necessary as HUD makes the transition to voucher-based housing assistance.

Gaynor will study the "Effects of Consolidation and Concentration on Nonprofit Hospitals." Heckman will evaluate the role of "Not-for-Profit Organizations in Manpower Training." Kremer will examine the role of "Nonprofit Organizations in Developing Countries," and Mocan will produce "A Comparison of Nonprofit and For-Profit Child Care Centers."



## Research Meeting of EFG Program

Nearly 60 members and guests of the NBER's Program on Economic Fluctuations and Growth met at Stanford University on January 31. Organizers Ricardo J. Caballero, NBER and MIT, and John H. Cochrane, NBER and University of Chicago, put together this agenda:

**Michael Woodford**, NBER and Princeton University, "Control of the Public Debt: A Requirement for Price Stability" (NBER Working Paper No. 5684)

Discussant: Christopher A. Sims, NBER and Yale University

**Lawrence Christiano** and **Martin S. Eichenbaum**, NBER

and Northwestern University, and **Charles Evans**, Federal Reserve Bank of Chicago, "Sticky Price and Limited Participation Models of Money: A Comparison" (NBER Working Paper No. 5804)

Discussant: David H. Romer, NBER and University of California, Berkeley

**James Hamilton**, University of California, San Diego, "Measuring the Liquidity Effect"

Discussant: Bennett T. McCallum, NBER and Carnegie Mellon University

**Olivier J. Blanchard** and **Michael Kremer**, NBER and MIT

"Disorganization" (NBER Additional Paper)

Discussant: Pierre-Olivier Gourinchas, Stanford University

**James Kahn** and **Jong-Soo Lim**, University of Rochester, "Skilled Labor — Augmenting Technical Progress in U.S. Manufacturing"

Discussant: Kevin M. Murphy, NBER and University of Chicago

**Robert F. Hall**, NBER and Stanford University, and **Charles Jones**, Stanford University, "The Productivity of Nations" (NBER Working Paper No. 5812)

Discussant: Edward C. Prescott, NBER and University of Minnesota

**Woodford** considers the role of limits on the permissible growth of public debt, like those stipulated in the Maastricht Treaty, in making price stability possible. He shows that variations in the present value of current and future primary government budgets necessarily result in price level instability. In the presence of sluggish price adjustment, the fiscal shocks disturb both real output and real interest rates. On the other hand, shocks of this kind can be eliminated by a Maastricht-type limit on the value of the public debt. Furthermore, an appropriate monetary policy rule can ensure price stability even in the face of other kinds of real shocks. Thus, the debt limit serves as a precondition for the common central bank in a monetary union to be charged with responsibility for maintaining a stable value for the common currency.

**Christiano, Eichenbaum, and Evans** provide new evidence that models of the monetary transmission mechanism should be consistent with at least the following facts: after a contractionary monetary policy shock, the aggregate price level

responds very little; aggregate output falls; interest rates initially rise; real wages decline by a modest amount; and profits fall. The limited participation model can account for all of these facts, but only if one is willing to assume a high labor supply elasticity (2 percent) and a high markup (40 percent). The shortcomings of both it and the sticky price model reflect the absence of labor market frictions, such as wage contracts or factor hoarding, which dampen movements in the marginal cost of production after a monetary policy shock.

**Hamilton** develops a measure of the immediate effect on the federal funds rate of an open market operation. He creates a proxy for the errors the Federal Reserve makes in forecasting the extent to which Treasury operations will add or drain reserves available to private banks. These errors induce fluctuations in bank reserves that have measurable consequences for the federal funds rate. He estimates that a reduction in nonborrowed reserves of \$30 million, if sustained for an entire 14-day reserve maintenance period, will cause the federal funds rate to rise by 10 basis points.

**Blanchard and Kremer** note that under central planning, many firms relied on a single supplier for many of their inputs. Transition has led to decentralized bargaining between suppliers and buyers. Under incomplete contracts or asymmetric information, bargaining may inefficiently break down. If chains of production are complex, so that many different parties must bargain, these inefficiencies may be dramatic. The mechanisms that mitigate these problems in the West can only play a limited role in transition. For example, the scope for long-term relations to reduce opportunistic behavior is limited when many existing firms are expected to disappear or change most of their suppliers in the future. The result has been disorganization, and a sharp decrease in output. Output seems to have fallen furthest for the goods with the most complex chains of production, and disorganization has played a more important role in the former Soviet Union than in Central Europe.

**Kahn and Lim** examine the role of skilled labor in the growth of total factor productivity. They use panel

data from manufacturing industries within the United States to assess the extent to which productivity growth in yearly cross-sections of U.S. manufacturing industries is tied to industry shares of skilled labor inputs. They find an explosion in skilled-labor augmenting technological progress during the period from approximately 1973 to 1981, coinciding with a period of suddenly in-

creasing wage inequality and rapid growth in the relative wages of educated and experienced workers. They also provide evidence from aggregate manufacturing data that confirm this shift pre- and post-1973.

Output per worker varies enormously across countries. **Hall and Jones** show that differences in governmental, cultural, and natural infrastructure are important sources of this

variation. A high-productivity country has institutions that favor production over diversion; is open to international trade; has at least some private ownership; speaks an international language; and is located in a temperate latitude far from the equator. A favorable infrastructure helps a country both by stimulating the accumulation of human and physical capital and by raising its total factor productivity.

## Industrial Technology and Productivity

Members of the NBER's Project on Industrial Technology and Productivity, led by Adam B. Jaffe of NBER and Brandeis University, met in Cambridge on February 14 to discuss some of the individual studies that are part of the overall project. The following papers were presented:

**Daniel Raff**, NBER and University of Pennsylvania, "What Happened at Highland Park?"

Discussant: Claudia Goldin, NBER and Harvard University

**Frank R. Lichtenberg**, NBER and Columbia University, and

**William Lehr**, Columbia University, "Computer Use and Productivity Growth in Federal Government Agencies, 1987 to 1992" (NBER Working Paper No. 5616)

Discussant: Daniel R. Feenberg, NBER

**Shane Greenstein**, NBER and University of Illinois, and **Timothy F. Bresnahan**, NBER and Stanford University, "Technical Progress and Co-Invention in Computing and in the Uses of Computers"

Discussant: G. Steven Olley, NBER and New York University

**Susan Helper**, Case Western Reserve University,

"Complementarity and Cost Reduction: Evidence from the Auto Supply Industry"

Discussant: Maryellen R. Kelley, Carnegie Mellon University

**J. Vernon Henderson**, NBER and Brown University, and **Randy Becker**, Brown University, "Effects of Air Quality Regulations on Decisions of Firms in Polluting Industries"

Discussant: Wayne Gray, NBER and Clark University

**Raff** studies total factor productivity growth at the Ford Motor Company from 1909 through 1914, the period generally taken to cover its transition from turn-of-the-century factory methods to true mass production. Annual growth rates were extremely large as compared to the rates for aggregates which economists usually see. Based on their timing, incremental improvements in technology and organization — owing to the implementation of interchangeable parts assembly and the rationalization of materials flow through the production process — that preceded the coming of the line appear to be strikingly important contributions to growth.

**Lehr and Lichtenberg** examine trends in computer usage and their effect on productivity growth for a sample of federal government agencies from 1987 to 1992. They link data from the Bureau of Labor Statistics on the growth in real output per employee with data from a marketing research firm, Computer Intelligence, on the growth in per capita computer assets for a sample of 44 federal agencies. They derive an estimated output elasticity for computers of 0.06, allowing them to conclude that computers contributed significantly to output growth. Moreover, the returns to computer investment appear to exceed those to other types of capital. There is also

a positive correlation between increased computer usage and compensation growth which is consistent with skill-biased technical change. Finally, telephone interviews with personnel from a subset of the agencies in their sample helped to verify the quality of the data and to confirm these overall findings, as well as suggesting several ways in which computers have enhanced productivity in the public sector.

**Bresnahan and Greenstein** examine the diffusion of client/server computing to users of large scale computing systems, a group that places extremely high value on technology. They examine detailed, user-based information about the

adoption of client/server and the replacement of host-based systems between 1989 and 1994. They argue that these adoption patterns can be understood in terms of the costs faced by buyers when adjusting to the new client/server platform. These costs are high and tied closely to the idiosyncracies and complexity of the buyer's computing organization. The potential adopters with the most valuable computing use also tend to be those with the highest adjustment costs. Thus, the earliest adopters of computing systems have the least valuable applications. The costs of adjusting to client/server also depend on whether market processes make this co-invention activity cheap or expensive.

Over the last 20 years, the success of Japanese manufacturing firms has brought renewed attention to the importance of cost reduction on existing products as a source of productivity growth. **Helper** uses survey data and field interviews from the auto supply industry to explore the determinants of average-cost reduction for a sample of 171 plants in the United States and Canada between

1988 and 1992. Her main result is that the determinants of cost reduction differ markedly between firms that had an employee suggestion program in 1988 and firms that did not. The two groups of firms achieved equal amounts of cost reduction, but did so in very different ways. Firms with a suggestion program saw their costs fall more if they also had "voice" relationships with customers and workers. Firms without a suggestion program gained no cost-reduction benefit from these programs; instead their cost reduction success was largely a function of increases in volume.

**Henderson and Becker** examine the effect of air quality regulation (related to ground level ozone) on the decisions of firms in four industries which are heavy polluters: industrial organic chemicals, plastics, metal containers, and wood furniture. Air quality regulation is much tougher in counties which are in non-attainment of national air quality standards. It also varies implicitly by plant size, with plants in the large-scale sector coming under regulation earlier and remaining under closer

scrutiny. Using Census data for 1963-92, and dividing the time into pre-regulation (before the mid-1970s), early regulation, and the mature era, the authors find that in all industries there is a big shift in plant births from non-attainment to attainment counties under regulation. The shift occurs earlier in the large-scale sectors. For three industries, the authors find an attempted expansion of the less regulated small-scale sector, which is successful for two of them. In terms of survival rates, there is evidence of grandfathering: survival rates of pre-regulation plants rise with the advent of regulation. Also, investment patterns change. New plants in the mature regulatory era in non-attainment areas have much larger initial (up-front) investments, because of the environmental negotiation process. These larger up-front investments also appear to increase later survival rates of these plants. While many of these findings seem reasonable, they are unintended consequences of regulation, and are leading to restructuring of key polluting industries.

## Program Meeting on Industrial Organization

About 40 members and guests of the NBER's Program on Industrial Organization met at the Bureau's California office on February 23 and March 1. Steven J. Berry, NBER and Yale University, and Judith A. Chevalier, NBER and the University of Chicago, organized this program.

**Daniel A. Akerberg**, Boston University, "Advertising, Learning, and Consumer Choice in Experience Good Markets: An Empirical Examination." Discussant: Sara F. Ellison, MIT.  
**Martin Pesendorfer**, Yale University, "Retail Sales: A Study of

Pricing Behavior in Supermarkets." Discussant: Peter Rossi, University of Chicago.

**Philip A. Haile**, University of Wisconsin, "Auctions with Resale Markets: An Application to U.S. Forest Service Timber Sales." Discussant: Kenneth Hendricks, University of British Columbia.

**Joel Podolny**, Stanford University, and **Andrea Shepard**, NBER and Stanford University, "When Are Technological Spillovers Local? Patent Citation Patterns in the Semiconductor Industry." Discussant: Steven J. Berry.

**Steven J. Berry** and **Ariel Pakes**, NBER and Yale University, and **James Levinsohn**, NBER and University of Michigan, "Estimating Differentiated Product Models from Combining Micro and Macro Data: Autos Once Again." Discussant: Peter C. Reiss, NBER and Stanford University.  
**Patrick S. Moreton** and **Pablo T. Spiller**, University of California, Berkeley, "Bidding Strategies in Interrelated Multi-Object Auctions: Evidence from the FCC Broadband PCS Spectrum Auctions." Discussant: Robert Gertner, NBER and University of Chicago.

**Ackerberg** analyzes different effects of advertising in a nondurable, experience good market. He presents a dynamic learning model of consumer behavior in which advertising has both "informative" effects and "prestige" or "image" effects. He estimates this model with consumer-level panel data that tracks grocery purchases and advertising exposure over time. In his data, the primary effect of advertising is to inform consumers.

**Pesendorfer** examines temporary price reductions, or sales, on ketchup products in supermarkets in Springfield, Missouri, between 1986 and 1988. He finds that demand at low price levels depends on past price choices, which suggests that there are intertemporal effects in demand. Further, the timing of sales is best explained by competition between retailers.

**Haile** presents a model of auctions with resale which he then applies to sales of timber harvesting contracts held by the U.S. Forest Service. After a contract is sold, there is often a considerable delay before harvesting must begin, and each firm's uncertainty about the value it places on the contract may be resolved in the interim. Because contracts can be transferred in some circumstances and always can be subcontracted, bidding may reflect the presence of a resale market in which the ex post gains to trade can be exploited. The results are consistent with the predictions of the model: First, control-

ling for the selection of the auction mechanism, first-price sealed bid auctions yield revenues which are at least as high as those from English auctions. This ranking is strict in one of the two regions studied. Second, individual bids in English auctions increase with the number of bidders. Neither of these results is consistent with the models of auctions without resale that underlie previous empirical studies of timber auctions, and the latter result is inconsistent with any known noncooperative model of auctions without resale.

Recent empirical research has provided some evidence of local technological spillovers across firm boundaries, but has provided little guidance as to how characteristics of research projects, labs, firms, or geographic areas may affect the likelihood that spillovers are local.

**Podolny** and **Shepard** use data on semiconductor patents with application dates between 1976 and 1990 and the citations among those patents as indicators of spillover effects. They find that common geographic location has a substantial and enduring effect on the probability of a spillover from one R and D project to another. Further, these effects are more important when the citing and cited patents are in technologically dissimilar areas. Interestingly, these effects are not larger in areas with greater technological activity; indeed the advantage of proximity appears to be negatively correlated with the

level of activity in the neighborhood of the at-risk patent.

**Berry, Levinsohn, and Pakes** extend their earlier research on estimating the demand for automobiles with the results from a new consumer-level dataset on new automobile purchases. Their technique allows consumer preferences to depend on both measured and unmeasured characteristics of available automobile models and on the household making the purchase decision. They find important interactions between these sets of characteristics, suggesting that household attributes such as age, family size, income, and rural location substantially influence preferences for different automotive features. The authors hope to build upon this work to analyze model design decisions by automobile manufacturers.

**Moreton** and **Spiller** explore the bidding strategies used by participants in the FCC's recent auction for Block C Broadband PCS spectrum licenses. They focus on two aspects that affect a bidder's expectations for winning a nearby license: the degree of competition for that license, and the attractiveness of that license to its strongest rival. They find that bidders are sensitive to the degree of competition in adjacent licenses and withdraw from markets at lower prices when confronted with rivals in adjacent markets that possess substantial cellular telephone license holdings.



## Productivity Meeting

The NBER's Program on Productivity held its spring meeting at the Bureau's offices on March 7. Program Director Zvi Griliches, also of Harvard University, and Samuel S. Kortum, NBER and Boston University, organized this agenda.

**Ice G. Branstetter**, NBER and Dartmouth College, and **Mariko Sakakibara**, University of California at Los Angeles, Japanese Research Consortia: A Microeconomic Analysis of Industrial Policy

Discussant: Rebecca Henderson, NBER and MIT

**Boyan Jovanovic**, NBER and New York University, "Obsolescence of Capital"

Discussant: Charles R. Hulten, NBER and University of Maryland

**Jonathan Putnam**, Charles River Associates, "The Value of International Patent Rights"

Discussant: Jonathan Eaton, NBER and Boston University

**Samuel S. Kortum**, and **Josh**

**Lerner**, NBER and Harvard University, "Technological Revolution or Stronger Protection: What is Behind the Recent Surge in Patenting?"

Discussant: Mehmet Yorukoglu, University of Chicago

**Edward N. Wolff**, NBER and New York University, "Spillovers, Linkages, and Technical Change"

Discussant: Wolfgang Keller, University of Wisconsin

**Branstetter** and **Sakakibara** undertake the first large-sample econometric study of Japanese government-sponsored research consortia, using firm-level data on research inputs and outputs to measure the impact of participation on the ex post research productivity of the firm. They find that frequent participation in these consortia has a positive impact on research expenditure and research productivity. Part of this impact arises from the increased knowledge spillovers that take place within these consortia. These results are useful in shedding light on the question of what role Japanese "industrial policy" played in Japanese technological innovation during the 1980s.

**Jovanovic** combines the vintage capital model with the assignment model, and studies the distribution of wages and rental incomes. Some of his findings are: 1) The machine-vintage premium is higher if skills are more dispersed. 2) The skill premium can be higher if technological progress is more rapid. 3) Obsolescence is faster than in the efficiency-units model, at least for older machines. 4) Low-skilled people, areas, or countries are "priced out" of the market for machines embodying advanced technology. 5) Faster technological

progress speeds up the diffusion of technology.

**Putnam** studies an inventor's decision to file for patent protection in each of an arbitrary set of countries, as a means of estimating the global value of patent rights, and the distribution from which patented inventions are drawn. Using oversampled, invention-level data from the 1974 international patent cohort, he estimates a model for the 18 leading patenting countries. His results are consistent with those of patent renewal models, except in the right tail of the distribution, where the international model imputes significantly more value (up to \$50 million worldwide) to the most valuable inventions. The international component of annual capitalized patent returns alone represents over \$14 billion in 1974 dollars, or about 21 percent of annual private business R and D in the countries under investigation. The average internationally protected patented invention generates about \$245,000 in patent rights, with over half the total value captured by the top 5 percent of inventions. With the exception of Japan, the largest developed countries appear to grant more value in patent rights at home than they hold abroad.

Applications for U.S. patents by U.S. inventors have taken a spectacular jump over the last decade. No comparable increase has occurred since early this century. **Kortum** and **Lerner** ask whether the jump in patenting reflects a new set of technological opportunities or a jump in the propensity to patent inventions. Conventional wisdom is that patents have fared better in the courts since the establishment of the Court of Appeals of the Federal Circuit by Congress in 1982. These authors evaluate the evidence for the hypothesis that this institutional change has increased inventors' propensity to patent.

Using U.S. input-output data for 1958 to 1987, **Wolff** finds that industry growth in total factor productivity (TFP) is related significantly to the TFP performance of supplying sectors, with an elasticity of almost 60 percent. R and D intensity is also a significant determinant of industry TFP growth, with an estimated return of about 10-13 percent, and the return to embodied R and D is around 43 percent. Direct productivity spillovers, from the technological progress made by supplying sectors, appear more important than spillovers from the R and D per-

formed by suppliers. They also play a key role in explaining changes in manufacturing TFP growth over time. Changes in the contribution made by direct productivity spillovers to TFP growth account for almost half of the

slowdown in TFP growth in manufacturing between 1958–67 and 1967–77, and 20 percent of the TFP growth recovery in this sector between 1967–77 and 1977–87. Changes in R and D intensity and

embodied R and D are relatively unimportant in explaining movements in manufacturing TFP growth over these three periods.

## DAE Program Meeting

Members of the NBER's Program on the Development of the American Economy held their spring meeting in Cambridge on March 14 and 15. Program Director Claudia Goldin, also of Harvard University, and John J. Wallis, NBER and University of Maryland, chose the following papers for discussion:

**Naomi R. Lamoreaux** and **Kenneth L. Sokoloff**, NBER and University of California,

Los Angeles, "Inventors, Firms, and the Market for Technology: U.S. Manufacturing in the Late Nineteenth and Early Twentieth Centuries"

**Shawn E. Kantor** and **Price V. Fishback**, NBER and University of Arizona, "The Political Economy of Workers' Compensation Benefit Levels, 1910–50"

**Eugene N. White**, NBER and Rutgers University, California

Banking in the Nineteenth Century: The Art and Method of the Bank of A. Levy

**Robert A. Margo**, NBER and Vanderbilt University, "Wages in California during the Gold Rush"

**Paul Rhode**, NBER and University of North Carolina, "California's Emergence as the Second Industrial Belt: the Pacific Coast Tire and Automobile Industries"

Recent scholarly literature explains the spread of in-house research laboratories during the early twentieth century by pointing to the information problems involved in contracting for technology. **Lamoreaux** and **Sokoloff** argue, by contrast, that these difficulties have been overemphasized — that, in fact, a substantial trade in patented inventions developed over the course of the nineteenth century, much of it taking the form of transactions conducted at arms-length through the market. This expansion of trade in technology made possible a growing division of labor, as inventors increasingly took advantage of their greater ability to sell off rights to patented technologies and focused their energies and resources on invention itself. Firms in turn responded to the expansion of this trade by developing capabilities that enabled them to learn about and assess externally generated inventions. Although it is true that by the early twentieth century large firms also were beginning to invest in

developing their internal inventive capabilities, in doing so they faced a number of significant problems. Most importantly, they had to overcome resistance to contracts requiring employees to sign over patents to their employers, and they had to reduce the high turnover rates that made such requirements effectively unenforceable. The increased costs of inventive activity and the greater risks borne by independent inventors by the early twentieth century helped firms make their case. But there was still a lot of organizational learning involved. Hence where other scholars have emphasized the difficulties of contracting for technology in the market and the relative ease of integrating invention and production within the firm, Lamoreaux and Sokoloff reverse the story. Economic actors at that time had a great deal of experience contracting for new technological ideas in the market; what they did not know how to do, and had to spend a great deal of time and energy learning, was managing cre-

ative individuals within the firm.

**Fishback** and **Kantor** note that in the case of workers' compensation legislation, most members of the key interest groups with a stake in the legislation expected to benefit from it. However, during the first 20 years of experience with workers' compensation, the various interest groups actively fought over the level of benefits paid because the benefit level determined each group's share of the rents created by workers' compensation. The disputes ultimately were settled by state legislators, who appear to have been focusing more on appeasing powerful interest groups than on pleasing the median voter or choosing an efficient political economic solution. In states where unions and political reform movements were weak, legislators appeared to ignore the demands of the numerous but politically weak nonunion workers, instead focusing their attention on the demands of employers. The employers' success in pressing for low benefits was tempered in

areas where organized labor was strong, where political reform movements led to shifts in party control of the houses of the legislature, and where agencies had been established to administer workers' compensation.

Although there is a large literature on banking in nineteenth century America, relatively little work has been done on the actual lending practices of banks. **White** examines the lending practices of the Bank of A. Levy. Using data from its loan book combined with census and other records, he produces a detailed picture of the loan portfolio. White shows that reputation played a key role. Furthermore, while the bank was on the agricultural frontier, it appears to have been well integrated into financial markets.

The California Gold Rush (1847–54) was an unusual “natural experiment” — an unexpected shock of tremendous size that required the costly reallocation of labor to a virtually unpopulated region. Using newly-collected archival data, **Margo**

presents the estimates of nominal and real wages in Gold Rush California. He finds that real wages rose sharply during the early years of the Rush (1848–52), declined sharply in 1852, and then remained roughly constant for the remainder of the decade. Although the Rush itself was transitory, it left California wages permanently higher, as the state integrated into the (high-wage) U.S. economy. **Margo** also estimates the “long-run” elasticity of labor supply into Gold Rush California. His estimates range between 2 and 3, roughly half of the comparable elasticity of labor supply into Alaska during the Pipeline era (1973–6).

California's emergence as America's second industrial belt is one of the most dramatic transformations in the U.S. economy over the 20th century. Yet this shift in the locus of production, markets, and resources has been virtually ignored in the economic history literature. **Rhode** investigates one key aspect of this transformation: the spread of mass-

production manufacturing to the Pacific Coast. He analyzes the economic forces leading to the establishment of the auto and tire branch plants in the West, and examines the concerns of many Westerners that branch plant production contributed to their region's status as an “economic colony” of the East. **Rhodes** emphasizes the growth of the regional market in explaining the location of these mass-production industries in the West. As the western market expanded, more firms found it profitable to set up western branches and the region's self-sufficiency increased. Contrary to the westerners' fears, the national firms proved quite responsive to local market conditions. An analysis comparing the minimum efficient scale of plant operations and regional sales reveals no significant lag in the establishment of western plants. Yet, in line with some of the concerns, the spillovers of these industries to California manufacturing appears limited.

## International Finance and Macroeconomics

Members and guests of the NBER's Program on International Finance and Macroeconomics, directed by Andrew K. Rose of University of California, Berkeley, met in Cambridge on March 21. Their agenda, organized by Rose and Charles M. Engel, NBER and University of Washington, was:

**Michael D. Bordo**, NBER and Rutgers University, and **Ronald MacDonald**, University of Strathclyde, “Violations of the Rules of the Game and the Credibility of the Classical Gold Standard, 1880–1914.” Discussants: Jose M. Campa, NBER and New York University, and Peter Garber, Brown University.

**V.V. Chari**, University of Minnesota, **Patrick Kehoe**, NBER, and

University of Pennsylvania, and **Ellen McGrattan**, NBER and Federal Reserve Bank of Minneapolis, “Monetary Shocks and Real Exchange Rates in Sticky Price Models of International Business Cycles.” (NBER Working Paper No. 5876).

Discussants: Alan C. Stockman, NBER and University of Rochester, and Dale Henderson, Federal Reserve System.

**Maurice Obstfeld**, NBER and University of California, Berkeley, and **Alan M. Taylor**, NBER and Northwestern University, “Nonlinear Aspects of Goods-Market Arbitrage and Adjustment: Heckscher's Commodity Points Revisited.”

Discussants: Menzie D. Chinn, NBER and University of California,

Santa Cruz, and Richard H. Clarida, NBER and Columbia University.

**Karen K. Lewis**, NBER and University of Pennsylvania, “Consumption, Stock Returns, and the Gains from International Risksharing.” (NBER Working Paper No. 5410).

Discussants: Michael P. Dooley, NBER and University of California, Santa Cruz, and Robert J. Hodrick, NBER and Columbia University.

**Kenneth A. Froot**, NBER and Harvard University, and **Emil Dabora**, GS First Boston, “How Are Stock Prices Affected by the Location of Trade?”

Discussants: Patrick K. Asea, NBER and University of California, Los Angeles, and Shang-Jin Wei, NBER and Harvard University.

**Bordo** and **MacDonald** examine the finding that the Classical gold standard represented a credible, well behaved, target zone system from the perspective of the well documented failure of countries to play by the rules of the game in the classical period. In particular, they test the hypothesis that a credible target zone can confer on a country a degree of independence in the operation of its monetary policy. They propose a number of ways of testing this proposition and implement them for a newly-created monthly database over the period 1880–1913. They demonstrate that the Classical gold standard worked in the way that the hypothesis predicted. This would seem to have an important bearing on the kind of institutional framework required for a modern day target zone (such as the exchange rate mechanism) to function effectively and, in particular, to weather speculative attacks.

**Chari, Kehoe** and **McGrattan** examine large and persistent deviations from purchasing power parity in the data on real exchange rates. Recent work has shown that to a large extent these movements are driven by deviations from the law of one price for traded goods. In the data, real and nominal exchange rates are about 6 times as volatile as relative price levels, and both are highly persistent, with serial correlations of 0.85 and 0.83, respectively. The authors develop a sticky price model with price discriminating monopolists, which produces deviations from the law of one price for traded goods. Their benchmark model, which has prices set for one quarter at a time and a unit con-

sumption elasticity of money demand, does not come close to reproducing these observations. A model which has producers setting prices for six quarters at a time and a consumption elasticity of money demand of 0.27 does much better. In it, real and nominal exchange rates are about three times as volatile as relative price levels and exchange rates are persistent, with serial correlations of 0.65 and 0.66 respectively.

**Obstfeld** and **Taylor** propose that analysis of purchasing power parity and the law of one price should explicitly take into account the possibility of “commodity points” — thresholds delineating a region of no central tendency among relative prices, possibly because of a lack of perfect arbitrage in the presence of transaction costs and uncertainty. Their model performs well using post-1980 data, and yields estimates that appear quite reasonable: adjustment outside the thresholds might imply half-lives of price deviations measured in months rather than years, and the thresholds correspond to popular rough estimates as to the order of magnitude of actual transport costs. The estimated commodity points appear to be related positively to objective measures of market segmentation, notably nominal exchange rate volatility.

Standard theoretical models predict that domestic residents should diversify their portfolios into foreign assets much more than is observed in practice. Whether this lack of diversification is important depends on the potential gains from risksharing. General equilibrium models and consumption data tend to find that the costs are small, typically less than

one half percent of permanent consumption. On the other hand, stock returns imply gains that are several hundred times larger. **Lewis** finds that there are significantly different trends in risk-adjusted consumption growth, primarily arising from either the much higher variability of stocks, or the higher degree of risk aversion required to reconcile an international equity premium. Furthermore, contrary to conventional wisdom, treating stock returns as exogenous does not necessarily imply greater gains.

**Froot** and **Dabora** examine pairs of large, “Siamese twin” companies whose stocks are traded around the world but have different trading and ownership habitats. The twins pool cashflows so, with integrated markets, twin stocks should move together. In contrast, the relative prices of twin stocks appear excessively correlated with the markets on which they are most intensively traded; that is, a twin’s relative price rises when the market on which it is relatively intensively traded rises. The authors examine several explanations for this phenomenon: the discretionary use of dividend income by parent companies; differences in parent-company expenditures; voting rights issues; currency fluctuations; ex-dividend-date timing issues; and tax-induced investor heterogeneity. Their results are not consistent with these explanations, but appear better explained by the hypotheses that: 1) country-specific sentiment shocks affect share price movements of locally-traded stocks in proportion to their trading/ownership intensity, or 2) investors are rational, but markets are segmented by frictions other than international transactions costs.



## Corporate Finance Members Meet

Members of the NBER's Program on Corporate Finance held their spring program meeting in Cambridge on April 11. Program Director Robert W. Vishny, also of the University of Chicago, chose the following papers for discussion:

**Kenneth A. Froot**, NBER and Harvard University, and **Paul O'Connell**, Harvard University,

"On Pricing of Intermediated Risks: Theory and Application to Catastrophe Reinsurance"

Discussant: Rene M. Stulz, NBER and Harvard University

**Rafael LaPorta**, Harvard University, and **Florencio Lopez-de-Silanes**, NBER and Harvard University, "The Benefits of Privatization: Evidence from Mexico"

Discussant: Luigi Zingales, NBER and University of Chicago

**Assem Safieddine**, Michigan State University, and **Sheridan Titman**, NBER and Boston College, "Debt and Corporate Performance: Evidence from Unsuccessful Takeovers"

Discussant: Laurie Hodrick, Columbia University

**Gregor M. Andrade**, University of Chicago, and **Steven N. Kaplan**, "How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed"

Discussant: David S. Scharfstein, NBER and MIT

**Brian Hall**, Harvard University, and **Jeffrey Liebman**, NBER and Harvard University, "Are CEOs Really Paid Like Bureaucrats?"

Discussant: Karen Wruck, Harvard University

**Froot** and **O'Connell** model the equilibrium price and quantity of risk transfer between firms and financial intermediaries. They show that equilibrium prices will be "high" in the presence of financing imperfections that make intermediary capital costly. Moreover, small changes in financial imperfections can give rise to large changes in price. Taking the U.S. catastrophe reinsurance market as an example and using detailed data covering 1970-94, they find that the price of reinsurance generally exceeds "fair" values, particularly in the aftermath of large events; that market power of reinsurers is not a complete explanation for such pricing; and that reinsurers' high cost of capital appears to play an important role.

Criticisms of privatization have centered around the possibility that the observed higher profitability of privatized companies comes at the expense of the rest of society. **LaPorta** and **Lopez-de-Silanes** focus on two of the most likely channels for social losses: 1) increased prices as firms capitalize on their market power; and 2) layoffs and lower wages as firms seek to roll back generous labor contracts. Using data for all 218 nonfinancial privatizations

that took place in Mexico between 1983 and 1991, they find that privatization is followed by a 24 percentage point increase in the ratio of operating income to sales. They decompose those gains in profitability as follows: 15 percent of the increase is attributable to higher product prices; 33 percent represents a transfer from laid-off workers; and the remaining 52 percent comes from productivity gains. Transfers from society to the firm are offset partially by taxes which absorb slightly over half the gains in operating income. Finally, deregulation appears to be associated with faster convergence to industry benchmarks.

In a sample of 573 unsuccessful takeovers, **Safieddine** and **Titman** find that on average the failed targets significantly increase their debt levels. Failed targets that increase their debt levels more than the median: are less likely to be taken over in the future; decrease investment; sell off assets; reduce employment; increase the focus of their firms; and have better operating performance in the five years after the takeover attempt than failed target firms that increase their debt levels less than the median. In addition, those failed target firms that

most increase their leverage outperform their benchmarks in the five years following the failed offer. The stock prices of the failed targets that increase their leverage less than the median do very poorly over the following five years if they are not subsequently taken over. This suggests that debt helps firms to remain independent, not because it entrenches managers, but because it commits the managers to making the improvements that would have been made by the bidding firm.

**Andrade** and **Kaplan** study 29 highly leveraged transactions (HLTs) of the 1980s that subsequently became financially distressed. High leverage, not poor firm performance or poor industry performance, is the primary cause of financial distress for these firms: all of the sample firms have positive operating income at the time of distress. The net effect of the HLT and the distress is to leave the firm's value slightly higher. Operating margins of the distressed firms increase immediately after the HLT, decline when the firms become distressed and while they are distressed, but then rebound after the distress is resolved. Consistent with some costs of financial distress, Andrade and

Kaplan find unexpected cuts in capital expenditures, undesired asset sales, and costly managerial delay in restructuring. However, the costs are modest on average. The authors conclude that the costs of financial distress are related to initial HLT capital, but not to the complexity of the firm's capital structure, the time spent in distress of default, or industry performance.

**Hall** and **Liebman** use a new 15-

year panel dataset of CEOs in large U.S. firms, and report a variety of pay-to-performance measures, using a broad measure of CEO compensation that includes changes in the value of CEO holdings of stock and stock options. They find that CEO compensation is highly responsive to firm performance. For example, for only a moderate change in firm performance, the compensation of the median CEO in their sample in-

creases by almost 50 percent, which represents about \$1.5 million. They also document that both the level of CEO compensation and the sensitivity of CEO compensation to firm performance have grown dramatically over the past 15 years. The compensation of the mean CEO in their sample increased by 207 percent from 1980 to 1994.

## Program Meeting on Monetary Economics

The spring program meeting of the NBER's Monetary Economics Program, whose director is N. Gregory Mankiw of Harvard University, took place in Cambridge on April 18. Susanto Basu, NBER and University of Michigan, and Stephen G. Cecchetti, NBER and Ohio State University, chose the following papers for discussion:

**Miquel Faig**, University of Toronto, "Investment Irreversibility in General Equilibrium: Capital Accumulation, Interest Rates, and the Risk Premium"

Discussant: Narayana Kocherlakota, Federal Reserve Bank of Minneapolis

**Jason G. Cummins**, New York University, and **Kevin A. Hassett** and **Stephen D. Oliner**, Federal Reserve Board, "Investment Behavior, Internal Funds, and Observable Expectations"

Discussant: Simon Gilchrist, Boston University  
**Joe Peck**, Boston College, and **Eric S. Rosengren**, Federal Reserve Bank of Boston, "The International Transmission of Financial Shocks: The Case of Japan"

Discussant: Anil K. Kashyap, NBER and University of Chicago

**Harald Uhlig**, Tilburg University, "Long-Term Debt and the Political Support for a Monetary Union"

Discussant: Enrico Spolaore, Ohio State University

**Daniel Levy**, Emory University, **Mark Bergen**, University of Minnesota, and **Shantanu Dutta**, University of Southern California, "State-Dependent Pricing and Price Rigidity: Direct Evidence from Store-Level Data"

Discussant: John V. Leahy, NBER and Harvard University

**Harold L. Cole**, Federal Reserve Bank of Minneapolis, and **Lee E. Ohanian**, University of Minnesota, "Shrinking Money and Monetary Business Cycles"

Discussant: A. Craig Burnside, The World Bank

Irreversibility depresses risk-free rates, especially in booms, and magnifies risk premiums, especially in downturns. **Faig's** model calibrated to U.S. data for 1929-94 shows that investment irreversibility has a positive effect on capital accumulation and growth. Even if this effect is small, it is associated with large effects on risk premiums and interest rates. Thus, without incredibly large coefficients of risk aversion, the model can deliver large risk premiums, low risk-free rates, procyclical premiums on risk, mean reversion of

asset prices, and realistic cyclical patterns of interest rates.

**Cummins**, **Hassett**, and **Oliner** use earnings forecasts from securities analysts to construct observable approximations to expected marginal  $q$  in a large firm-level panel dataset. They find that investment responds significantly — in both economic and statistical terms — to "observable" marginal  $q$ . They use the earnings forecasts to construct the component of beginning-of-period internal funds that is uncorrelated with expected future profitability. They find that this

measure of liquidity is not correlated with investment behavior, even for selected subsamples of firms — those paying no dividends and those without bond ratings — that have been found to be "liquidity constrained" in previous studies.

**Peck** and **Rosengren** investigate the extent to which the sharp decline in Japanese stock prices was transmitted to the United States via U.S. branches of Japanese parent banks, and identify a supply shock to U.S. bank lending that is independent of U.S. loan demand. They find that

binding risk-based capital requirements associated with the decline in the Japanese stock market resulted in a decline in commercial lending by Japanese banks in the United States that was both economically and statistically significant.

**Uhlig** examines the role of long-term debt for the political support of a monetary union or, more generally, an inflation-reduction policy. The central idea is that the decision about membership in the union leads to a redistribution between debtors and creditors, if they are holding long-term debt with a nominally fixed interest rate. A government of a high inflation country might try to exploit this effect strategically by selling more long-term debt denominated in its own currency at a fixed nominal rate to its citizens. Uhlig shows that the effect on political support is unclear. While the "creditor effect" of increasing the number of agents holding domestically denominated debt helps to generate support for joining the union, the "tax effect" of having to raise more taxes in order to pay for the increased real debt payments after a successful monetary union works in the opposite way.

Finally, in studying a number of special cases, Uhlig argues that recent debt management policy in Italy probably eroded the political support for actions aimed at enhancing the chances of EMU membership.

**Levy, Bergen, and Dutta** use a unique store-level dataset to document the variation in individual product price rigidity that can be explained by variation in "state." Unlike the common practice of characterizing the state in terms of the effect of the inflation rate on relative prices, they characterize the state in terms of the nature of the cost shocks that the seller experiences. They suggest three features of cost shocks that affect the variation in price rigidity; variation in: 1) their persistence; 2) the information available on them; and 3) their size. They use actual retail and wholesale prices, and a measure of upstream commodity costs, of 12 refrigerated and frozen orange juices. The data were collected weekly over a three-year period at a large midwestern supermarket chain, Dominick's. They find that agents react to cost shocks of different persistence, size, and information in different ways. Since the

nature of a cost shock is an important aspect of the state of market conditions, the evidence that retailers and manufacturers react differently to these cost shocks supports the assumption of state-dependent pricing rules, which are frequently employed in new Keynesian models of the cost of price adjustment.

In the postwar period velocity has risen so sharply in the United States that the ratio of money to nominal output has fallen by a factor of three. **Cole and Ohanian** analyze the implications of shrinking money for the real effects of a monetary shock in two classes of equilibrium monetary business cycle models: limited participation (liquidity) models, and predetermined (sticky) price models. They show that the liquidity model predicts that a rise in velocity leads to a substantial reduction in the real effects of a monetary shock. In sharp contrast, the real effects of a monetary shock in the sticky price model are largely invariant to changes in velocity. The authors also provide evidence that suggests that the real effects of monetary shocks have fallen over the postwar period.

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#### **Disorganization**

**Olivier Blanchard and Michael Kremer**

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## Bureau Books

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### Tax Policy Volume

*Tax Policy and the Economy, Volume 11*, edited by James M. Poterba, is available in paperback from the MIT Press for \$15.00. This volume includes the papers presented at the NBER's Eleventh Annual Tax Policy Conference, which was held in Washington last October. The topics that are discussed range from health insurance for poor women and children, and medical savings accounts, to the consequences of shifting from the current income tax system to a federal tax on consumption, or sales.

This volume should appeal to a wide audience, including economics professors and students, government policymakers and advisors, and tax professionals. Poterba directs the NBER's research on taxation and is a professor of economics at MIT.

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### In Pursuit of Leviathan

*In Pursuit of Leviathan*, by Lance Davis, Robert Gallman, and Karen Gleiter, is available from the University of Chicago Press for \$80.00. This volume, which is part of the NBER monograph series on "Long-Term Factors in Economic Development," is a comprehensive economic history of the rise and decline of American whaling in the nineteenth century. The authors explore the forces that encouraged the industry's expansion and collapse, as well as its responsiveness to its problems. This volume will interest economic historians and students of this era of American history.

Davis and Gallman are research associates in the NBER's Program on the Development of the American Economy. Davis teaches economics at California Institute of Technology, Gallman at the University of North Carolina, Chapel Hill. Gleiter is also affiliated with UNC, Chapel Hill.

### Reducing Inflation

*Reducing Inflation*, edited by Christina D. Romer and David H. Romer, is available from the University of Chicago Press for \$58.00. This NBER volume is the result of a Bureau project designed to aid economists and policymakers in understanding the pros and cons of reducing the rate of inflation. It includes essays by 16 distinguished economists who analyze the appropriateness of low inflation as a goal for monetary policy and discuss possible strategies for reducing inflation. They look at both day-to-day issues in the conduct of monetary policy and fundamental reforms of monetary institutions.

Both Christina and David Romer are NBER research associates in the Programs in Monetary Economics and Economic Fluctuations and Growth and professors of economics at University of California, Berkeley.

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## Current Working Papers

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## NBER Working Papers

### **The CEA: From Stabilization to Resource Allocation**

**Martin Feldstein**

NBER Working Paper No. 5908

January 1997

JEL No. A11

Monetary Economics and Public Economics

This paper traces the changing role of the Council of Economic Advisers (CEA). In the 50 years since its creation, the CEA's focus has shifted from the design of policies for achieving full employment to advising the federal government on its much-enlarged spending and tax activities. The CEA's original attention to achieving cyclical stability through fiscal policy diminished as economists changed their views about the inherent stability of the economy and the usefulness of fiscal policy. With the shift of macroeconomic policy to the Federal Reserve, the CEA's macroeconomic role has diminished but not disappeared. The rapid growth of government spending during the past five decades has greatly increased the role for the CEA in seeking efficient resource allocation.

### **Offshore Hedge Funds: Survival and Performance, 1989–95**

**Stephen J. Brown,  
William N. Goetzmann,  
and Roger G. Ibbotson**

NBER Working Paper No. 5909

January 1997

JEL Nos. N20, G23

Asset Pricing

We examine the performance of the offshore hedge fund industry from 1989 through 1995 using a database that includes defunct as well as currently operating funds. The industry is characterized by high attrition

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Abstracts of all papers issued since January 1997 are presented below. For previous papers, see past issues of the *NBER Reporter*. Working Papers are intended to make results of NBER research available to other economists in preliminary form to encourage discussion and suggestions for revision before final publication. They are not reviewed by the Board of Directors of the NBER.

rates of funds and little evidence of differential managerial skill. We develop endogenous style categories for relative fund performance measures, and find that repeat-winner and repeat-loser patterns in the data are largely attributable to style effects in that data.

### **World Trade Flows, 1970–92, with Production and Tariff Data**

**Robert C. Feenstra, Robert E. Lipsey, and Harry P. Bowen**

NBER Working Paper No. 5910

January 1997

JEL Nos. C80, F14

International Trade and Investment

This paper describes two databases dealing with world bilateral trade flows: the World Trade Database (WTDB) assembled by Statistics Canada, which contains bilateral trade flows for all countries during 1970–92, classified according to the Standard International Trade Classification, Revision 2 (with some modification); and the Compatible Trade and Production (COMTAP) database assembled by the Organization for Economic Cooperation and Development (OECD), which contains production of manufactured goods in OECD countries and bilateral trade flows between these countries and all their trading partners over 1970–85, classified according to the International Standard Industrial Classification, Revision 2. These databases are available to academic users on the CD-ROM “NBER Trade Database, Disk 2: World Trade Flows, 1970–92,” which can be ordered for \$50 from the Publications Department, NBER, 1050 Massachusetts Avenue, Cambridge, MA 02138. Also contained on the CD-ROM is information on countries’ factor endowments, tariff and nontariff barriers for selected countries, and input-output tables for the United Kingdom and the United States. The WTDB database is made

available under a license with Statistics Canada, the terms of which are described herein, and the COMTAP database is made available by permission of the OECD.

### **The Moral Hazard of Insuring the Insurers**

**James G. Bohn and Brian J. Hall**

NBER Working Paper No. 5911

January 1997

Public Economics

State guaranty funds are quasi-governmental agencies that provide insurance to policyholders against the risk of insurance company failure. But insurance provided by guaranty funds, like all insurance, creates moral hazard problems, especially for companies that are insolvent or nearly insolvent. The key insight of this paper is that, because of the time lag between premium payments and losses (which is especially lengthy in long-tail lines), writing policies is one way for insurance companies to borrow money (that is, from policyholders). Moreover, the existence of guaranty fund insurance enables insurance companies, even very risky ones, to borrow from policyholders at rates that do not reflect the insurer’s risk of default. Thus, one way for insurance companies to “game” the guaranty fund system is to engage in excessive premium writing. Consistent with this idea, we find that insolvent property and casualty insurance companies tend to have had very high premium growth before they failed. More than one-third of the failed insurance companies had premium growth of more than 50 percent in the two years before failure. Moreover, this excessive premium growth was more pronounced in long-tail lines than in short-tail lines. We also find that greater regulatory resources are associated with less “gaming” of the system.

### **Pension and Social Security Wealth In The Health and Retirement Study**

**Alan L. Gustman, Olivia S. Mitchell, Andrew A. Samwick, and Thomas L. Steinmeier**

NBER Working Paper No. 5912

February 1997

Aging and Labor Studies

Together, pensions, Social Security, and health insurance account for half of the wealth held by all households represented in the Health and Retirement Study (HRS), 60 percent of the total wealth of HRS households in the 45th to 55th wealth percentiles, and 48 percent of wealth for households in the 90th to 95th wealth percentiles. The HRS surveys households whose members were aged 51 to 61 in 1992, and obtains descriptions of pension plans from the respondents’ employers. Pension accrual profiles, income and wealth distributions by type, wealth-income ratios, and accrued wealth by pension status are also explored.

### **Reinsurance for Catastrophes and Cataclysms**

**David M. Cutler and Richard J. Zeckhauser**

NBER Working Paper No. 5913

February 1997

Asset Pricing and Public Economics

This paper examines the optimal design of insurance and reinsurance policies. We first consider reinsurance for “catastrophes:” risks that are large for any one insurer but not large for the reinsurance market as a whole. Reinsurance for catastrophes is complicated by adverse selection. Optimal reinsurance in the presence of adverse selection depends critically on the source of information asymmetry. When information on the probability of a loss is private but the magnitude of the loss is public, then optimal reinsurance will employ a

deductible-style excess-of-loss policy. When information on the magnitude of a loss is private but the probability of a loss is common, optimal reinsurance covers small and large risks, but makes the primary insurer responsible for moderate risks. There is a dramatic divergence between these designs, which suggests that traditional, rule-of-thumb approaches to design are likely to be misguided.

We then consider reinsurance for "cataclysms:" risks that are so large that a loss can threaten the solvency of reinsurance markets as a whole. Some cataclysms can arise from a single event, such as a major earthquake or hurricane, while others derive from common risks — changes in conditions that affect large numbers of individuals — such as the liability revolution or escalating medical care costs. We argue that cataclysms must be reinsured either in broad securities markets or by the government. Beyond their one-period loss potential, cataclysms pose an additional risk: risk levels change over time. A simulation model traces the implications of evolving risk levels for long-term patterns of losses and premiums, which reflect learning about loss distributions. Premium risk emerges as an important component of risk, which is not adequately diversified by reinsurance and primary insurance markets.

### **TFPG Controversies, Institutions, and Economic Performance in East Asia**

**Dani Rodrik**

NBER Working Paper No. 5914

February 1997

JEL Nos. O30, F43, O47, O53

Economic Fluctuations and Growth and International Trade and Investment

The controversy over the appropriate partitioning of East Asian growth into accumulation versus technical change has overlooked a fundamental indeterminacy in mea-

surement. As a result, we cannot rule out the possibility that East Asia in fact has experienced a tremendous amount of technological and labor-saving progress. Further, an index of institutional quality (drawn from work by Knack and Keefer [1995] and Easterly and Levine [1996]) does exceptionally well in rank-ordering East Asian countries according to their growth performance. A parsimonious specification containing only initial income, initial education, and institutional quality accounts for virtually all of the variation in the growth performance in the region, even when institutional quality is instrumented. Finally, the experience of Hong Kong, which has had a flat investment ratio since the 1960s, is consistent with the idea that making the transition from a low-investment economy to a high-investment economy requires a hands-on government.

### **Cyclical Productivity with Unobserved Input Variation**

**Susanto Basu and**

**Miles S. Kimball**

NBER Working Paper No. 5915

February 1997

JEL Nos. E32, D24

Economic Fluctuations and Growth

In this paper, we derive and estimate relationships governing variable utilization of capital and labor for a firm solving a dynamic cost-minimization problem. Our method allows for: imperfect competition; increasing returns to scale; unobserved changes in utilization and technology; unobserved fluctuations in the factor prices of capital and labor and in the shadow price of output; and the lack of a value-added production function. We can estimate the parameters of interest without imposing specific functional forms or using restrictions, simply by assuming the existence of a representative consumer. We find that variable utilization of capital and labor explains

40–60 percent of the cyclical of the Solow residual in U.S. manufacturing, so true technology shocks have a lower correlation with output than the literature assumes. Controlling for variable utilization also eliminates the evidence for increasing returns to scale. Our model-based proxies for variable utilization are valid even when extending the workweek of capital has two potential costs: a shift premium paid to workers, and a higher rate of depreciation. Thus, these proxies can be used under very general conditions in a wide range of empirical work.

### **Contract Form and Procurement Costs: The Impact of Compulsory Multiple Contractor Laws in Construction**

**Orley Ashenfelter, David Ashmore, and Randall Filer**

NBER Working Paper No. 5916

February 1997

JEL Nos. K11, K42

Law and Economics

It is claimed that many regulatory rules enforce inefficiencies in order to achieve the appearance of cost control. We assess these claims by measuring the effect of New York state's compulsory multiple contractor law on the cost of public construction in New York City. Multiple contractor laws, which exist in many states, prohibit the use of general contractors in order to promote the appearance of competition. Contrasting construction costs between buildings with identical blind cost estimates indicates that this law increases public construction costs by 8 percent and increases construction delays by more than a calendar year.

## **Employment Policy of the Middle Reagan Years: What Didn't Happen and Why It Didn't Happen**

**Martin Feldstein**

NBER Working Paper No. 5917

February 1997

JEL No. J6

Public Economics and Labor Studies

This paper examines the record of employment and unemployment between 1982 and 1986 and discusses a variety of cyclical and structural employment policies that were considered but not implemented during 1982–4 when I served as chairman of the Council of Economic Advisers. Employment rose by 11 million jobs during the cyclical recovery of 1982–6, lowering the unemployment rate from 10.8 percent to 6.6 percent. Even before the recovery was visible, the Reagan administration supported the tight Federal Reserve policy designed to reverse the high inflation at the end of the 1970s. The policies for reducing structural unemployment that were considered but not enacted at the time have become law in later years: a gradual decline in the real minimum wage, the full taxation of unemployment insurance, and a work requirement for those on welfare.

## **Analyzing Investments Whose Histories Differ in Length**

**Robert F. Stambaugh**

NBER Working Paper No. 5918

February 1997

JEL Nos. G11, G15, C11

ASSET Pricing

This study explores multivariate methods of investment analysis using a sample of return histories that differ in length across assets. The longer histories provide more information about "moments" of returns for both the longer-history and the shorter-history assets. To account for the

remaining parameter of uncertainty, or "estimation risk," portfolio opportunities are characterized by a Bayesian predictive distribution. Examples involving emerging markets demonstrate the value of using the combined sample of histories and accounting for estimation risk, as compared to truncating the sample to produce equal-length histories or ignoring estimation risk by using maximum-likelihood estimates.

## **The Evolving External Orientation of Manufacturing Industries: Evidence from Four Countries**

**José Campa and Linda S. Goldberg**

NBER Working Paper No. 5919

February 1997

International Finance and Macroeconomics and International Trade and Investment

There have been significant changes in the external orientation of manufacturing industries in the United States, Canada, and the United Kingdom, but not in Japan. These increases in external orientation are in industry export shares, import penetration, and imported input use in production. Over the past two decades, U.S. industries have experienced a particularly dramatic increase in use of imported inputs, accompanied by highly variable patterns of industry net external orientation. Although similar manufacturing industries have strong export orientation in all countries, these same industries have profoundly different patterns of import penetration, imported input use, and net external exposure to exchange rate and trade policy changes across countries.

## **On the Uses of Benefit-Cost Reasoning in Choosing Policy Toward Global Climate Change**

**David F. Bradford**

NBER Working Paper No. 5920

February 1997

JEL No. D61

Public Economics

In the debate about the correct discount rate to use in evaluating policy with regard to climate change, which covers the entire world and extends for centuries, the conditions for deploying benefit-cost analysis often are overlooked. Where income distributional effects of policies are large and one cannot take for granted compensating adjustment in other policy instruments affecting distribution, the simple aggregation of gains and losses is not likely to provide a convincing basis for action, as an ethical matter, or predictor of policy, as a political matter.

## **Regionalism and Multilateral Tariff Cooperation**

**Kyle Bagwell and Robert W. Staiger**

NBER Working Paper No. 5921

February 1997

JEL Nos. F02, F13, F15

International Trade and Investment

We consider a three-country "world" in which each country's import market is served by competing exporters from its two trading partners. We assume that weak multilateral enforcement mechanisms prevent governments from implementing efficient trade policies through multilateral agreements that require tariffs to conform to the most-favored-nation (MFN) principle. We then ask whether exceptions from MFN aimed at forming preferential agreements can lead to lower external tariffs, and thus to a more efficient tariff structure under the



multilateral agreement. We identify three opposing effects of preferential agreements on the multilateral tariff structure in this setting. The first, a *tariff complementarity effect*, works to reduce the desired external tariffs of countries that join in a preferential agreement. The two other effects of preferential agreements arise only when enforcement issues at the multilateral level are considered. One of these, the *punishment effect*, weakens the ability of the member countries of a preferential agreement to punish deviations from the multilateral agreement, thereby interfering with the ability of countries to sustain low tariffs under the multilateral agreement. The other, the *tariff discrimination effect*, allows countries to discriminate against those who would "free ride" under MFN, and therefore works to increase the desired external tariffs of countries that join together in a preferential agreement. The relative strengths of these three effects determine the impact of a preferential agreement on the tariff structure under the multilateral agreement. Our findings suggest that preferential agreements can have their most desirable effects on the multilateral system when the degree of multilateral cooperation is low.

## **Equilibrium Unemployment**

**Joao Gomes, Jeremy Greenwood, and Sergio Rebelo**

NBER Working Paper No. 5922

February 1997

JEL Nos. E24, E32

Economic Fluctuations and Growth

A search-theoretic general equilibrium model of frictional unemployment is consistent with some of the key regularities of unemployment over the business cycle. In the model, the return to a job moves stochastically. Agents can choose either to quit and search for a better job or to continue working. The search

process generates job offers that agents can accept or reject. Two distinguishing features of current work relative to the existing business cycle literature on labor market fluctuations are: 1) the decision to accept or reject jobs is modeled explicitly, and 2) there is imperfect insurance against unemployment.

## **The Uruguay Round and Welfare in Some Distorted Agricultural Economies**

**James E. Anderson**

NBER Working Paper No. 5923

February 1997

JEL Nos. F13, F14, O13, O20

International Trade and Investment

There is widespread concern that the Uruguay Round may reduce the welfare of developing countries through its effect on world agricultural prices. Reduced distortions in agricultural prices among major supplying nations are predicted to increase basic food prices and to decrease some important export prices, such as for coffee and cotton. It appears that raising the food prices paid by food importers must be bad for them, while reducing world coffee and cotton prices appears to be bad for exporters of those products. Appearances may be deceiving, however, since theory shows that a *distortion effect* operates alongside the standard *terms-of-trade effect*.

In an analysis of the Uruguay Round's impact on nine agricultural economies, I find distortion effects that are many times larger than terms-of-trade effects. Using a simple Computable General Equilibrium model, I find that in the nine developing economies, there are domestic agricultural distortions in 15 markets, along with the distortions caused by hundreds of 4-digit non-agricultural tariffs and quotas. In three of the nine countries, the distortion effect reverses the impact of the terms-of-trade effect. In two other

countries, the distortion effect raises a trivial terms-of-trade effect to around 1 percent of national income.

## **Labor Market Shifts and the Price Puzzle Revisited**

**Alan B. Krueger**

NBER Working Paper No. 5924

February 1997

JEL Nos. J31

Labor Studies

This paper examines the relationship between price growth and skill intensity across 150 manufacturing industries between 1989 and 1995. There are two main findings. First, wage growth and increases in intermediate goods prices are passed through to final product prices roughly in proportion to their factor shares. Second, product prices have grown relatively less in sectors that use less-skilled labor more intensively. This latter finding is consistent with the Stolper-Samuelson theory of expanded trade with countries that are abundant in less-skilled workers, as well as with some models of technological change.

## **Uncertain Duration of Reform: Dynamic Implications**

**Guillermo A. Calvo and Allan Drazen**

NBER Working Paper No. 5925

February 1997

JEL Nos. F41, E32

International Finance and Macroeconomics

We develop a framework for studying the effects of policies of uncertain duration on consumption dynamics under both complete and incomplete markets. We focus on the dynamic implications of market incompleteness, specifically on the lack of state-contingent bonds. We consider two policies: pure increasing of output and reducing tariffs (trade liberalization). With complete

markets, the output-increasing policy leads to flat consumption. With no contingent assets, consumption jumps on the announcement of the policy, continues to rise as long as the policy is in effect, and collapses when it is abandoned. A similar consumption path obtains with a trade liberalization in the realistic case of low elasticity of substitution and no rebate of tariffs. Market incompleteness rationalizes the existence of gradual changes in consumption.

### **A Model of Investor Sentiment**

**Nicholas Barberis, Andrei Shleifer, and Robert W. Vishny**

NBER Working Paper No. 5926

February 1997

JEL No. 313

Asset Pricing

Recent empirical research in finance has uncovered two families of pervasive regularities: *underreaction* of stock prices to news such as earnings announcements; and *overreaction* of stock prices to a series of good or bad news. In this paper, we present a parsimonious model of investor sentiment — that is, of how investors form beliefs — that is consistent with the empirical findings. The model is based on psychological evidence and produces both underreaction and overreaction for a wide range of parameter values.

### **Immigrant Inflows, Native Outflows, and the Local Labor Market Impacts of Higher Immigration**

**David Card**

NBER Working Paper No. 5927

February 1997

JEL No. J2

Labor Studies

This paper uses 1990 Census data to study the effects of immigrant inflows on the labor market opportunities of natives and older immi-

grants. I divide new immigrants, older immigrants, and natives into distinct skill groups and focus on the outcomes within each group and within cities. An important first question is whether inflows of new immigrants lead to outflows of natives or earlier immigrants who have the same skills. Even after accounting for mobility decisions, I find that inter-city migration flows of natives and older immigrants largely are unaffected by new immigrant inflows. Inflows of new immigrants are associated with lower employment rates among natives and earlier immigrants, but with fairly small effects on the relative wage structure. These estimates imply that immigrant arrivals between 1985 and 1990 depressed the employment rate of low-skilled natives in major U.S. cities by 1–2 percentage points on average, and by substantially more in cities with a high proportion of immigrants.

### **Measuring Positive Externalities from Unobservable Victim Precaution: An Empirical Analysis of Lojack**

**Ian Ayres and Steven D. Levitt**

NBER Working Paper No. 5928

February 1997

JEL Nos. H23, K42

Public Economics

Private expenditures on crime reduction have potentially important externalities. Observable measures such as barbed-wire fences and deadbolt locks may shift crime to those who are unprotected, imposing a negative externality. Unobservable precautions, on the other hand, may provide positive externalities, since criminals cannot determine a priori who is protected. Focusing on one specific form of victim precaution, Lojack, we provide the first thorough empirical analysis of the magnitude of such externalities. Because installing Lojack does not reduce the

likelihood that an individual car will be stolen, any decrease in the aggregate crime rates attributable to Lojack is an externality from the perspective of the individual Lojack purchaser. We find that the presence of Lojack is associated with a sharp fall in auto theft in central cities and a more modest decline in the remainder of the state. Rates of other crimes do not change appreciably. Our estimates suggest that, at least historically, the marginal social benefit of an additional unit of Lojack has been as much as 15 times greater than the marginal social cost in high crime areas. Those who install Lojack in their cars, however, obtain less than 10 percent of the total social benefits of Lojack, causing Lojack to be undersupplied by the free market. Current insurance subsidies for the installation of Lojack appear to be well below the socially optimal level.

### **The Evolution of Advanced Large Scale Information Infrastructure in the United States**

**Shane M. Greenstein, Mercedes M. Lizardo, and Pablo T. Spiller**

NBER Working Paper No. 5929

February 1997

Productivity

Is private industry investing in backbone digital technology in a manner consistent with social policy? To address this question, we assemble highly disaggregate data and compute indexes for the geographic distribution of advanced backbone information technology in computing and telecommunications, focusing on recent changes in the indexes. Our evidence suggests that the stock of advanced information technology capital and access to it became distributed across the United States more evenly between the mid-1980s and early-1990s. In light of these findings, there needs to be careful rethinking of the current policy con-

cerns about the distribution of backbone technologies.

### **To Each According To...? Markets, Tournaments, and the Matching Problem With Borrowing Constraints**

**Raquel Fernández and Jordi Galí**

NBER Working Paper No. 5930

February 1997

JEL Nos. D52, E44, J41

Economic Fluctuations and Growth

We compare the performance of markets and tournaments as allocative mechanisms in an economy with borrowing constraints. Our model consists of a continuum of individuals who differ in their initial wealth and ability level (for example, students) and who are assigned to a continuum of investment opportunities or inputs of different productivity (for example, schools of different qualities). With perfect capital markets, both mechanisms achieve efficient allocation, although markets generate higher aggregate consumption because of the waste associated with the production of signals under tournaments. However, when borrowing constraints are present, tournaments dominate markets in terms of aggregate output and, for sufficiently powerful signaling technologies, in terms of aggregate consumption.

### **Within Group "Structural" Tests of Labor-Market Discrimination: A Study of Persons with Serious Disabilities**

**David S. Salkever and Marisa E. Domino**

NBER Working Paper No. 5931

February 1997

JEL No. I1

Health Care and Labor Studies

Measures of labor-market discrimination usually are derived from comparisons of market outcomes for

avored versus disfavored groups, after controlling for productivity-related individual characteristics. When the disfavored group is heterogeneous, one can relate variations in the intensity of discrimination to market outcomes within the group. We use this approach to test for employment and wage discrimination against persons with various types of disabilities. Measures of "social distance" and employer judgments of "employability" are controls for the intensity of discrimination. However, in a national sample of adults with serious disabilities, employment discrimination effects are in the "wrong" direction and wage effects are unstable. Thus, variability in labor market outcomes among different types of disabilities is not explained well by variations in discrimination intensity that are correlated with social distance and employer attitudes. We conjecture that differences in available support services by type of disability may help to explain this variability.

### **Reciprocity, Nondiscrimination, and Preferential Agreements in the Multilateral Trading System**

**Kyle Bagwell and Robert W. Staiger**

NBER Working Paper No. 5932

February 1997

JEL Nos. F02, F13, F15

International Trade and Investment

We present a framework for understanding and interpreting reciprocity and non-discrimination, the two principles that are the pillars of the multilateral trading system as embodied in GATT and its successor, the WTO. We show that GATT's principle of reciprocity serves to neutralize the world-price effects of a country's trade policy decisions. Hence GATT can deliver efficient trade-policy outcomes for its member governments provided that the exter-

nalities associated with trade intervention travel through world prices. Then we establish that externalities indeed travel in this way if and only if tariffs also conform to the principle of nondiscrimination. In this way, the principles of reciprocity and nondiscrimination can work together to deliver efficient outcomes for the multilateral trading system. Within our framework we also consider the implications of preferential agreements for the multilateral trading system. The introduction of free trade agreements complicates the way in which externalities are transmitted across countries, and in this environment the principle of reciprocity can no longer deliver efficient multilateral outcomes for its member governments. However, we do find a limited place for customs unions in the multilateral trading system, provided that the member countries of the union have similar political preferences. As these conditions are quite stringent, we offer little support for the hypothesis that the principle of reciprocity can deliver an efficient multilateral trade agreement in the presence of preferential agreements. Instead, our results support the view that preferential agreements pose a threat to the existing multilateral system.

### **Macroeconomic Fluctuations and the Allocation of Time**

**Robert E. Hall**

NBER Working Paper No. 5933

February 1997

JEL No. E32

Economic Fluctuations and Growth

What are the fundamental driving forces behind macroeconomic fluctuations? In particular, why do people spend more time working in booms and less in recessions? These are basic questions of macroeconomics. Recent thinking has emphasized technology shifts, preference shifts,

and changes in government purchases as the likely driving forces. It is useful to distinguish between atemporal and intertemporal effects of the driving forces. Under standard assumptions, the technology shift has no effect through atemporal channels because income and substitution effects exactly offset each other. A straightforward decomposition of employment movements attributes most of them to the atemporal effects of preference shifts.

### **Shifts in U.S. Relative Wages: The Role of Trade, Technology, and Factor Endowments**

**Robert E. Baldwin and Glen G. Cain**

NBER Working Paper No. 5934

February 1997

JEL Nos. F10, J31

International Trade and Investment

This paper investigates three hypotheses to account for the observed shifts in U.S. relative wages of less educated compared to more educated workers during 1967 to 1992: increased import competition; changes in the relative supplies of labor of different education levels; and changes in technology. Our analysis relies on a basic relation of the standard general equilibrium trade model that links changes in product prices to factor price changes and factor shares, along with information about changes in the composition of output, trade, within-industry factor use, and factor supplies. For 1967 to 1973, we conclude, the relative increase in the supply of well-educated labor was the dominant economic force that narrowed the wage gap among workers of different education levels. The wage gap continued to narrow during the rest of the 1970s, but our empirical results are not clear enough to conclude that the continued increase in the relative supply of more educated workers

again was the main factor shaping relative wages.

In a reversal of the previous trend, the wage gap between more educated and less educated workers widened sharply from 1980 to 1993, despite the continued relative increase in the supply of workers with more education. We find that increased import competition cannot account for the rise in wage inequality among the major education groups, although it could have contributed to the decline in the wages of the least educated workers (those who had completed one to eleven years of schooling). Instead, we find that technical progress which saves less educated labor and is more rapid in some manufacturing sectors intensively using highly educated labor is the dominant force in widening the wage gaps among college educated workers, workers with a completed high school education, and workers with one to eleven years of schooling. Finally, we use the Deardorff-Staiger model, which allows changes in the factor content of trade to reveal the effects of trade on relative factor prices. Our empirical tests reinforce the conclusion that increased import competition during 1977 to 1987 was not the dominant force in widening the wage gap between more educated and less educated labor between those years.

### **Understanding China's Economic Performance**

**Jeffrey D. Sachs and Wing Thye Woo**

NBER Working Paper No. 5935

February 1997

JEL Nos. O53, O57, P51

Economic Fluctuations and Growth

Broadly speaking, two schools of thought have emerged to interpret China's rapid growth since 1978: the experimentalist school and the convergence school. The experimentalist school attributes China's successes

to the evolutionary, experimental, and incremental nature of China's reforms. Specifically, the resulting noncapitalist institutions are claimed to be successful in 1) agriculture, where land is not owned by the farmers; 2) township and village enterprises which are owned collectively by rural communities; and 3) state-owned enterprises where increased competition and wage incentives, but not privatization, have been emphasized.

The convergence school holds that China's successes are the consequence of its institutions being allowed to converge with those of nonsocialist market economies, and that China's economic structure at the start of reforms is a major explanation for the rapid growth. China had a high population density heavily concentrated in low-wage agriculture, a condition that was favorable for labor-intensive export-led growth in other parts of East Asia. The convergence school also holds that China's gradualism results primarily from a lack of consensus over the proper course, with power still divided between market reformers and old-style socialists; and that the "innovative" non-capitalist institutions are responses to China's political, and not to its economic, circumstances.

Perhaps the best test of the two approaches is to ask whether China's policy choices in fact are leading to institutions harmonized with normal market economies or to more distinctive innovations. In this regard, the recent policy trend has been towards institutional harmonization rather than institutional innovation, suggesting that the government accepts that the ingredients for a dynamic market economy are already well-known.

## Is There Private Information in the FX Market?

### The Tokyo Experiment

Takatoshi Ito, Richard K. Lyons, and Michael T. Melvin

NBER Working Paper No. 5936

February 1997

JEL Nos. F31, G15

Asset Pricing and International Finance and Macroeconomics

Although the common view is that private information in the foreign exchange market does not exist, we provide evidence to the contrary. Our evidence comes from the introduction of trading in Tokyo during the lunch hour. The variance of lunch returns doubles when trading is introduced, which cannot be attributable to public information, since the flow of public information did not change with the trading rules. Having eliminated public information as the cause, we exploit the pattern of volatility over the entire day to discriminate between two alternatives: private information and pricing errors. Three key results support the importance of private information: First, the U-shape of the volatility distribution flattens; greater revelation over lunch leaves a smaller share for the morning and afternoon, it appears. Second, the U-shape tilts upward, an implication of information whose private value is transitory. Finally, the morning exhibits a clear U-shape when Tokyo closes during lunch, and this disappears when trading is introduced.

## Neglected Effects on the Uses Side: Even a Uniform Tax Would Change Relative Goods Prices

Don Fullerton and Diane Lim Rogers

NBER Working Paper No. 5937

February 1997

JEL No. H22

Public Economics

Fundamental tax reform may change relative prices of consumption goods and therefore may have important effects on the uses side that are ignored by most general equilibrium simulation models. For a uniform rate of tax, in our model, results on the uses side are driven by the nonuniform tax system being replaced. Similar effects occur under any uniform and comprehensive tax reform, whether the current system is replaced by a consumption tax, a wage tax, or a pure income tax. Any such reform, which eliminates the current preferential treatment of housing, would impose an additional one-time levy on the elderly; any reform that eliminates the current double taxation of corporate capital would reduce the relative prices of corporate-capital-intensive goods bought by the poor.

## Location and Technological Change in the American Glass Industry During the Late-Nineteenth and Early-Twentieth Centuries

Naomi R. Lamoreaux and Kenneth L. Sokoloff

NBER Working Paper No. 5938

February 1997

JEL Nos. O3, N0, L0

Development of the American Economy

Scholars have attempted to explain geographic clustering in inventive activity by arguing that it is connected with clustering in production or new investment. They have offered three possible reasons for this link: invention occurs as a result of learning by doing; new investment encourages experimentation with novel techniques; and, there are local information flows that make inven-

tors more fertile in areas where producers are concentrated. We test these theories by studying geographic patterns of production and invention in the glass industry during the late-nineteenth and early-twentieth centuries. We find that the patterns deviate significantly from what the theories would predict, and we offer the alternative hypothesis that inventive activity proceeded most intensively in areas where markets for technology had developed most fully — that is, where there were localized networks of institutions that mobilized information about technological opportunities and mediated relations among inventors, suppliers of capital, and those who would commercially develop or exploit new technologies.

## Patterns of Intra- and Inter-State Trade

Holger C. Wolf

NBER Working Paper No. 5939

February 1997

JEL Nos. O51, F11, F12, F14, F15

International Trade and Investment

Recent studies suggest that *intra*-national trade is "excessive" compared to *international* trade. National trade barriers provide an intuitive explanation for this home bias. A dataset on trade between U.S. states, however, reveals that home bias extends to sub-national units. The data suggest three additional stylized facts: First, shipment distances are shorter for intermediate than for final goods. Second, states located close to each other tend to have similar production patterns. Third, trade flows are higher among states with similar production patterns. The stylized facts are consistent with a complementary explanation of home bias resulting from a spatial clustering of production driven by natural and created comparative advantage.

## Technology, Trade, and Wages

James D. Adams

NBER Working Paper No. 5940

February 1997

JEL Nos. J3, O3, L3, F1

Labor Studies and Productivity

In recent years considerable effort has been devoted to the *description* of wage structure. This research has documented a rising return to education, unobserved skills, and work experience. However, there appears to be little research into the causes of the change in structure. This paper seeks to fill the gap by studying the impact of domestic technology, foreign technology, and trade on U.S. wages.

Empirically, I devise measures of foreign and domestic R and D *inputs* for six sectors of the private U.S. economy, and of R and D *outputs* for 24 manufacturing industries. Holding time and industry effects constant, I find that: 1) in most cases technology has the same, rather than opposite, effect on wages at both skill levels; 2) a rise in the foreign share in world innovation or U.S. patents decreases U.S. wages; 3) an increase in the U.S. share in world innovation or U.S. patents raises U.S. wages, especially for the less skilled; and 4) the stock of world innovation and U.S. patents decreases real wages, especially for the less skilled. Turning to the relative skilled wage, I find that the stock of world innovation or U.S. patents increases the skill differential. Holding technology constant, I find mixed results for trade. Effects of trade on real wages are generally insignificant once time effects are taken into consideration.

Together the findings suggest that sectoral labor immobility is an important part of the interaction between the U.S. labor market, technology, and trade. They also suggest that technology is a key explanatory element in the twists of the wage struc-

ture in recent years, and that, *in and of itself*, trade may not be an important determinant of real wages.

## Technological Change and Wages: An Inter-Industry Analysis

Ann P. Bartel and Nachum Sicherman

NBER Working Paper No. 5941

February 1997

JEL Nos. J31, J24, O33

Labor Studies

Previous research has found that wages in industries characterized as "high tech," or subject to higher rates of technological change, are higher. In addition, there is evidence that skill-biased technological change is responsible for the dramatic increase in the earnings of more educated workers relative to less educated workers that took place during the 1980s. In this paper, we match a variety of industry-level measures of technological change to a panel of young workers observed between 1979 and 1993 and examine the role of unobserved heterogeneity in explaining the positive relationships between technological change and wages, and between technological change and the education premium. We find that the wage premium associated with technological change is attributable primarily to the sorting of better workers into those industries. In addition, we find that the education premium associated with technological change is the result of an increase in demand for the innate ability or other observable characteristics of more educated workers.

## Protection for Sale: An Empirical Investigation

Pinelopi K. Goldberg and Giovanni Maggi

NBER Working Paper No. 5942

February 1997

JEL No. F1

International Trade and Investment

In the recent political economy literature on trade policy, Grossman and Helpman's (1994) "Protection for Sale" model is prominent. This model yields clear predictions for the cross-sectional structure of trade protection. Our paper aims to check whether the predictions of the Grossman-Helpman model are consistent with the data and, if so, to estimate its two key structural parameters: the government's valuation of welfare relative to contributions, and the fraction of the voting population represented by a lobby. We find that the pattern of protection in the United States in 1983 is consistent with the basic predictions of the model. Our estimate of the government's valuation of welfare relative to contributions is surprisingly high; the weight of welfare in the government's objective function is estimated to be between 50 and 88 times the weight of contributions.

## Integration, Cointegration, and the Forecast Consistency of Structural Exchange Rate Models

Yin-Wong Cheung and Menzie D. Chinn

NBER Working Paper No. 5943

February 1997

International Finance and Macroeconomics

We generate exchange rate forecasts using some popular monetary models of exchange rates in conjunction with several estimation techniques. We propose an alternative set of criteria for evaluating forecast rationality which entails the following requirements: the forecast and the actual series have the same order of integration; are cointegrated; and have a cointegrating vector consistent with long-run unitary elasticity of expectations. When these conditions hold, we consider the forecasts to be "consistent."

We find that it is fairly easy for the generated forecasts to pass the first requirement. However, cointegration fails to hold as the forecasts extend farther out. At the one-year-ahead horizon, for example, most series and their respective forecasts do not appear cointegrated. Of the cointegrated pairs, the restriction of unitary elasticity of forecasts-with-respect-to-actual does not appear to be rejected in general. The exception to this pattern is in the case of the error correction models in the longer subsample. Imposing a unitary coefficient restriction, we find fewer instances of consistency, but we find a relatively higher proportion of the identified cases of consistency at the longer horizons.

### **Interest Rate Targeting and the Dynamics of Short-Term Rates**

**Pierluigi Balduzzi, Giuseppe Bertola, Silverio Foresi, and Leora Klapper**

NBER Working Paper No. 5944  
February 1997  
JEL Nos. E43, E52  
Monetary Economics

We find that in 1989–96, when U.S. monetary policy targeted overnight Fed funds rates tightly, the volatility and persistence of spreads between target and term Fed funds levels were larger for longer-maturity loans. We show that such patterns are consistent with an expectational model where target revisions are infrequent and predictable. In our model, the (autoco-) variance of the spreads of term Fed funds rates from the target increases with maturity because longer-term rates are influenced more heavily by persistent expectations of future target changes.

### **Empirical Patterns of Firm Growth and R&D Investment: A Quality Ladder Model Interpretation**

**Tor Jakob Klette and Zvi Griliches**

NBER Working Paper No. 5945  
February 1997  
JEL Nos. D21, D43, L10, L13  
Productivity

We present a model of endogenous firm growth with R and D investment and innovation as the engines of growth. Our objective is to present a framework that can be used for microeconomic analysis of firm performance in high-tech industries. We employ a partial equilibrium model for firm growth, drawing on the quality ladder models in the macro growth literature, but also on the literature on patent races and on the discrete choice models of product differentiation. We examine to what extent the assumptions and the empirical content of our model are consistent with the findings that have emerged from empirical studies of growth, productivity, R and D and patenting at the firm level. Our analysis shows that the model fits well such empirical patterns as 1) a skewed size distribution of firms with persistent differences in firm sizes; 2) firm growth (roughly) independent of firm size (the so-called Gibrat's law); and 3) R and D investment proportional to sales. It also fits a number of other empirical patterns.

### **Accounting for Future Costs in Medical Cost-Effectiveness Analysis**

**David Meltzer**

NBER Working Paper No. 5946  
February 1997  
JEL Nos. I18, D61  
Health Care and Productivity

Most medical cost-effectiveness analyses include future costs only for

related illnesses, but this approach is controversial. This paper demonstrates that cost-effectiveness analysis is consistent with lifetime utility maximization only if it includes all future medical and nonmedical expenditures. Estimates of the magnitude of these future costs suggest that they may substantially alter both the absolute and the relative cost-effectiveness of medical interventions, particularly when an intervention increases length of life more than quality of life. In older populations, current methods overstate the cost-effectiveness of interventions which extend life as compared to interventions which improve the quality of life.

### **On the Optimality of Interest Rate Smoothing**

**Sergio Rebelo and Danyang Xie**

NBER Working Paper No. 5947  
February 1997  
JEL Nos. E31, E43, E52, O42  
Economic Fluctuations and Growth and Monetary Economics

This paper studies some continuous-time cash-in-advance models in which interest rate smoothing is optimal. We consider both deterministic and stochastic models. In the stochastic case, we obtain two results of independent interest: 1) we study what is, to our knowledge, the only version of the neoclassical model under uncertainty that can be solved in closed form in continuous time; and 2) we show how to characterize the competitive equilibrium of a stochastic continuous time model that cannot be computed by solving a planning problem. We also discuss the scope for monetary policy to improve welfare in an economy with a suboptimal real competitive equilibrium, focusing on the particular example of an economy with externalities.

## **Retiree Health Insurance and the Labor Force Behavior of Older Men in the 1990s**

**David M. Blau and  
Donna B. Gilleskie**

NBER Working Paper No. 5948  
February 1997  
JEL Nos. J26, I1  
Health Care

We estimate the impact of employer-provided retiree health insurance on the rate at which men aged 51–62 enter and exit the labor force and switch jobs. The models we estimate are an approximation of the decision rules implied by a dynamic stochastic model of employment behavior of older individuals. We use data from the Health and Retirement Survey (HRS), which contains more detailed and accurate measures of retiree health insurance than those used in most previous studies. Our results show that availability of employer-provided retiree health insurance (EPRHI) increases the rate of exit from employment by 2 percentage points per year on average if the individual shares the cost of the insurance coverage with the firm, and by 6 percentage points if the firm pays the entire cost. The impact of EPRHI on the annual rate of labor force exit increases with age, reaching 9 percentage points by age 61. These are larger than the effects estimated in previous studies. The accurate and detailed health insurance measures available in the HRS help account for the larger effects that we find. Controlling for unobserved heterogeneity, which is not accounted for in previous studies, also has a substantial impact on the estimates.

## **The Genesis and Evolution of Social Security**

**Jeffrey A. Miron and  
David N. Weil**

NBER Working Paper No. 5949  
March 1997  
JEL Nos. H55, N42  
Development of the American Economy  
and Public Economics

We examine the creation of Social Security during the Great Depression, and its evolution since then, asking in particular to what extent the program as it exists today is the same as what was created in 1935 and 1939. We find that there has been surprising continuity. Much of the program's growth was built in from its inception. The replacement rate and the ratio of benefits to payrolls today are roughly at the levels designed into the original legislation. Payroll tax rates today are higher than had been planned, in part because of the failure to accumulate a trust fund during the program's early years. The change in the ratio of contributors to beneficiaries which has taken place over the last 60 years was anticipated fully. The most dramatic changes in Social Security's functioning have come not from legislation, but from changes in the environment in which the program operates. Before the Depression, retirement was unlikely and often involuntary. Higher life expectancy, lower labor force participation, and better health have undermined Social Security's original purpose, a form of insurance. We also find that the Depression itself had surprisingly little influence on the design chosen for Social Security.

## **Heterogeneous Information Arrival and Option Pricing**

**Patrick K. Asea and Mthuli Ncube**

NBER Working Paper No. 5950  
March 1997  
JEL Nos. G13, D52  
Asset Pricing

We model the arrival of heterogeneous information in a financial market as a doubly-stochastic Poisson process (DSPP). We explore the implications for pricing stock, index, and foreign currency options of the assumption that the underlying security evolves as a mixed diffusion DSPP. We derive an intertemporal Capital Asset Pricing Model and demonstrate that accounting for the arrival of heterogeneous information may minimize the ubiquitous pricing bias — “smile effect” — of standard option pricing models. We propose a conceptually simple but numerically intensive maximum likelihood estimator of the parameters of a DSPP. Our simulation study verifies the adequacy of the asymptotic approximations in finite samples.

## **Lending Cycles**

**Patrick K. Asea and  
S. Brock Blomberg**

NBER Working Paper No. 5951  
March 1997  
JEL Nos. E32, E24, C33  
Economic Fluctuations and Growth

We investigate the lending behavior of banks by exploiting a rich panel dataset on the contract terms of approximately 2 million commercial and industrial loans granted by 580 banks between 1977 and 1993. Using a Markov switching panel model, we demonstrate that banks change their lending standards — from tightness to laxity — systematically over the cycle. We then use an efficient minimum chi-square estimator to examine the relationship between the cyclical component of aggregate unemployment and bank lending standards when both variables are determined jointly and endogenously in a system of simultaneous equations with mixed, continuous/discrete, dependent variables. The patterns we uncover suggest that lax lending standards that tend to occur during



*expansions* exert considerable influence on the dynamics of aggregate fluctuations.

## **Efficient Rules for Monetary Policy**

**Laurence Ball**

NBER Working Paper No. 5952

March 1997

JEL No. E52

Economic Fluctuations and Growth and Monetary Economics

In this paper, I define an efficient rule for monetary policy as one that minimizes a weighted sum of the variance of output and inflation. I derive several results about the efficiency of alternative rules in a simple macroeconomic model. First, efficient rules can be expressed as "Taylor rules" in which interest rates respond to output and inflation. But the coefficients in efficient Taylor rules differ from the coefficients that fit actual policy in the United States. Second, inflation targets are efficient. Indeed, the set of efficient rules is equivalent to the set of inflation-target policies with different speeds of adjustment. Finally, nominal-income targets are not merely inefficient, but also disastrous: they imply that output and inflation have infinite variances.

## **The Sociology of Groups and the Economics of Incentives: Theory and Evidence on Compensation Systems**

**William E. Encinosa III, Martin Gaynor, and James B. Rebitzer**

NBER Working Paper No. 5953

March 1997

JEL Nos. I1, D23, L21

Health Care

This paper incorporates the sociological concept of "group norms" into an economic analysis of pay systems. We use a behavioral microeconomic model and a unique survey of medical groups to examine the theoretical

and empirical relationship between group norms and incentive pay. Our findings suggest that, at least for medical groups, norms are binding constraints in the choice of pay practices. While group norms matter, the patterns in the data suggest that they are not *all* that matters. Analysis of the preferences and activities of individual physicians indicates that factors highlighted by the economic theory of agency, notably income insurance and multi-task considerations, also shape pay policies. We conclude that the sociological concept of group norms *augments* rather than replaces more conventional economic analyses of pay practices.

## **The Optimum Quantity of Money: Theory and Evidence**

**Casey B. Mulligan and Xavier Sala-i-Martin**

NBER Working Paper No. 5954

March 1997

JEL Nos. E52, E61, E63

Economic Fluctuations and Growth and Monetary Economics

We propose a simple and general model for computing the Ramsey-optimal inflation tax, which includes several models from the previous literature as special cases. We show that it cannot be claimed that the Friedman rule is always optimal (or always nonoptimal) on theoretical grounds. Whether the Friedman rule is optimal depends on conditions related to the shape of various relevant functions. One contribution of this paper is to relate these conditions to *measurable* variables, such as the interest rate or the consumption elasticity of money demand. We find that it tends to be optimal to tax money when there are economies of scale in the demand for money (that is, the scale elasticity is smaller than one) and/or when money is required for the payment of consumption or wage taxes. We find that it tends to

be optimal to tax money more heavily when the interest elasticity of money demand is small. We present empirical evidence on the parameters that determine the optimal inflation tax. Calibrating the model to a variety of empirical studies yields an optimal nominal interest rate of less than 1 percent per year, although that finding is sensitive to the calibration.

## **Entry, Exit, Embodied Technology, and Business Cycles**

**Jeffrey R. Campbell**

NBER Working Paper No. 5955

March 1997

JEL Nos. E22, E32, L16

Economic Fluctuations and Growth

This paper studies the entry and exit of U.S. manufacturing plants over the business cycle and compares the results with those from a vintage capital model augmented to reproduce observed features of the life cycle of the plant. Looking at the entry and exit of plants provides new evidence supporting the hypothesis that shocks to embodied technological change are a significant source of economic fluctuations. In the U.S. economy, the entry rate covaries positively with output and total factor productivity growth, and the exit rate leads all three of these. A vintage capital model in which all technological progress is embodied in new plants reproduces these patterns. In the model economy, a persistent improvement to embodied technology induces obsolete plants to cease production, causing exit to rise. Later, as entering plants embodying the new technology become operational, both output and productivity increase.

## **Computing Inequality: Have Computers Changed the Labor Market?**

**David H. Autor, Lawrence F. Katz,  
and Alan B. Krueger**

NBER Working Paper No. 5956

March 1997

Labor Studies

This paper examines the effect of technological change and other factors on the relative demand for workers with different education levels and on the recent growth of U.S. educational wage differentials. We use a simple supply-demand framework to interpret changes in the relative quantities, wages, and wage-bill shares of workers by education in the aggregate U.S. labor market in each decade since 1940 and over the 1990 to 1995 period. The results suggest that the relative demand for college graduates grew more rapidly on average during the past 25 years (1970–95) than during the previous three decades (1940–70). The increased rate of growth of relative demand for college graduates beginning in the 1970s did not lead to an increase in the college/high school wage differential until the 1980s, because the growth in the supply of college graduates increased even more sharply in the 1970s before returning to historical levels in the 1980s. The acceleration in demand shifts for more-skilled workers in the 1970s and 1980s relative to the 1960s is accounted for entirely by an increase in within-industry changes in skill utilization rather than between-industry employment shifts. Industries with large increases in the rate of skill upgrading in the 1970s and 1980s versus the 1960s are those with greater growth in employee computer usage, more computer capital per worker, and larger shares of computer investment as a share of total investment. The results suggest that the spread of computer technology may “explain” as much as 30 to

50 percent of the increase in the rate of growth of the relative demand for more-skilled workers since 1970.

## **Consolidation in the Medical Care Marketplace: A Case Study from Massachusetts**

**Jason R. Barro and  
David M. Cutler**

NBER Working Paper No. 5957

March 1997

Health Care

We examine consolidation in the Massachusetts hospital market. We find that consolidation is driven primarily by a large decline in the demand for hospital beds, resulting from increased enrollment in managed care and technological changes. Three primary forces motivate the drive to consolidate: the desire for closure; for economies of scale; and for network creation.

## **Are U.S. Multinationals Exporting U.S. Jobs?**

**S. Lael Brainard and  
David A. Riker**

NBER Working Paper No. 5958

March 1997

JEL Nos. J23, F23

International Trade and Investment

Many allege that multinationals are “exporting” U.S. jobs when they expand their operations abroad. This paper investigates the extent to which expansion of offshore production by U.S. multinationals reduces labor demand at home and at other offshore locations. Using a panel on U.S. multinationals and their foreign affiliates between 1983 and 1992, we find that foreign affiliate employment is a modest substitute at the margin for U.S. parent employment. There is much stronger substitution between workers at affiliates in alternative low-wage locations. In contrast, activities performed by affiliates at locations with different workforce

skill levels in the same region appear to be complements. These results suggest a vertical division of activities among countries with different workforce skill levels: workers in developing countries compete with each other to perform the activities most sensitive to labor costs. When wages in developing countries, such as Mexico, fall by 10 percent, U.S. parent employment falls by 0.17 percent, while affiliates in other developing countries, such as Malaysia, lay off 1.6 percent of their workforce.

## **U.S. Multinationals and Competition from Low Wage Countries**

**David A. Riker and  
S. Lael Brainard**

NBER Working Paper No. 5959

March 1997

JEL Nos. J23, F23

International Trade and Investment

It is often argued that the globalization of production places workers in industrialized countries in competition with their counterparts in low-wage countries. We examine a firm-level panel of foreign manufacturing affiliates owned by U.S. multinationals between 1983 and 1992 and find evidence to the contrary. Affiliate activities in developing countries appear to be complementary to, rather than substituting for, affiliate activities in industrialized countries. Workers do compete across affiliates, but the competition is between affiliates in countries with similar workforce skill levels. These results suggest that multinationals with affiliates in countries at different stages of development decompose production across borders into complementary stages that differ by skill intensity. The implied complementarity of traded intermediate inputs has important implications for the empirical debate over trade, employment, and wages.

## **The Great Depression as a Watershed: International Capital Mobility over the Long Run**

**Maurice Obstfeld and Alan M. Taylor**

NBER Working Paper No. 5960  
March 1997

JEL Nos. F33, N20  
Development of the American Economy, International Finance and Macroeconomics, and International Trade and Investment

This paper surveys the evolution of international capital mobility since the late nineteenth century. We begin with an overview of empirical evidence on the fall and rise of integration in the global capital market. Our discussion of institutional developments focuses on the use of capital controls and the pursuit of domestic macroeconomic policy objectives in the context of changing monetary regimes. A fundamental *macroeconomic policy trilemma* has forced policymakers to trade off among conflicting goals. The natural implication of the trilemma is that capital mobility has prevailed and expanded under circumstances of widespread political support, either for an exchange-rate subordinated monetary policy regime (for example, the gold standard), or for a monetary regime geared mainly toward domestic objectives at the expense of exchange-rate stability (for example, the recent float). Through its effect on popular attitudes toward both the gold standard and the legitimate scope for government macroeconomic intervention, the Great Depression emerges as the key turning point in the recent history of international capital markets.

## **Leverage and House-Price Dynamics in U.S. Cities**

**Owen Lamont and Jeremy C. Stein**

NBER Working Paper No. 5961  
March 1997

JEL Nos. G32, R31, E44  
Corporate Finance

In this paper, we use city-level data to analyze the relationship between homeowner borrowing patterns and house-price dynamics. Our principal finding is that in cities where homeowners are more leveraged — that is, have higher loan-to-value ratios — house prices react more sensitively to city-specific shocks, such as changes in per-capita income. This finding is consistent with recent theories which emphasize the role of collateralized borrowing in shaping the behavior of asset prices.

## **Inflation Targeting: Some Extensions**

**Lars E. O. Svensson**

NBER Working Paper No. 5962  
March 1997

JEL Nos. E42, E52, E58  
Asset Pricing, International Finance and Macroeconomics, Monetary Economics

I extend previous analysis of the implementation of inflation targeting to: monetary policy responses to different shocks; consequences of model uncertainty; effects of interest rate smoothing and stabilization; a comparison with nominal GDP targeting; and implications of forward-looking behavior. Model uncertainty, output stabilization, and interest rate stabilization (or smoothing) all call for a more gradual adjustment of the conditional inflation forecast toward the inflation target. The conditional inflation forecast is the natural intermediate target during inflation targeting.

## **Was the Great Depression a Watershed for American Monetary Policy?**

**Charles W. Calomiris and David C. Wheelock**

NBER Working Paper No. 5963  
March 1997

JEL Nos. E42, E50, N12  
Development of the American Economy and Monetary Economics

The Great Depression changed the institutions that govern monetary policy. These changes included: a departure from the gold standard; the opening of a new avenue for monetizing government debt; changes in the structure of the Federal Reserve System; and new monetary powers for the Treasury. Ideological changes accompanied the institutional changes.

We examine whether and how these changes mattered for post-Depression monetary policy. With respect to the period 1935–41, the tools of Fed policy, but not its goals or tactics, changed. Structural reforms weakened the Federal Reserve relative to the Treasury, and removed a key limit on the monetization of government debt. The increased power of the Treasury to determine the direction of policy, and the departure from gold along with the new “technology” for monetizing government debt, produced a new (albeit small) inflationary bias in monetary policy that lasted until the Treasury-Fed Accord of 1951.

The Fed regained some independence with the Accord of 1951; it returned to its traditional (pre-Depression) operating methods. The procyclical bias in these procedures — along with pressures to monetize government debt — explains how the Fed stumbled into an inflationary policy in the 1960s. Depression-era changes — especially the departure from the gold standard in 1933 and the relaxation of an important con-

straint on deficit monetization in 1932 — made this inflationary policy error possible, and contributed to the persistence of inflationary policy.

### **Private School Vouchers and Student Achievement: An Evaluation of the Milwaukee Parental Choice Program**

**Cecilia E. Rouse**

NBER Working Paper No. 5964

March 1997

JEL No. I20

Children, Labor Studies, Public Economics

In 1990, Wisconsin became the first state in the country to provide vouchers to low-income students to attend non-sectarian private schools. In this paper, I use a variety of estimation strategies and samples to estimate the effect of the program on math and reading scores. First, since schools selected students randomly from among their applicants if the school was oversubscribed, I compare the academic achievement of students who were selected to those who were not. Second, I present instrumental-variables estimates of the effectiveness of private schools (relative to public schools), using the initial selection as an instrumental variable for attendance at a private school. Finally, I used a fixed-effects strategy to compare students enrolled in the private schools to a sample of students from the Milwaukee public schools. I find that the Milwaukee Parental Choice Program had a positive effect on the math achievement of those who attended a private school, but no benefit for reading scores. The results are fairly robust to data imputations and sample attrition, but these limitations should be kept in mind when interpreting the results.

### **International Portfolio Diversification with Generalized Expected Utility Preferences**

**Joshua Aizenman**

NBER Working Paper No. 5965

March 1997

JEL Nos. F30, F36

International Finance and Macroeconomics

This paper revisits the Home Bias Puzzle: the relatively low international diversification of portfolios. I suggest that part of the diversification puzzle may be attributable to reliance on the conventional Capital Asset Pricing Model as the benchmark that predicts patterns of diversification. I compare the asset diversification patterns of agents who maximize a generalized expected utility (GEU) to the diversification of agents who maximize the conventional expected utility (EU). Specifically, I derive the patterns of diversification for agents who maximize a “rank-dependent” expected utility, attaching more weight to “bad” than to “good” outcomes, in contrast to the probability weights used in a conventional expected utility maximization. I show that agents who maximize a GEU exhibit first order risk aversion and tend to refrain from diversification, in contrast to agents who maximize the EU. For a given covariance structure, I identify a “cone of diversification:” that is, the range of domestic and foreign yields leading to a positive demand for both equities. Greater downside risk aversion increases the threshold of yields leading to diversification, shifting the cone of diversification upwards and rightwards. Thus, greater downside risk aversion narrows the range of foreign yields leading to diversification for a given domestic yield. *Ceteris paribus*, greater downside risk aversion reduces the feasible heterogeneity of normalized excess yields associated with diversification. Consequently, I

argue that first order risk aversion should be added to the explanatory factors that account for the observed diversification patterns.

### **Community Choice and Local Public Services: A Discrete Choice Approach**

**Thomas J. Nechyba and Robert P. Strauss**

NBER Working Paper No. 5966

March 1997

JEL Nos. H73, R20

Public Economics

This paper uses a discrete choice approach to estimate the impact of local fiscal and other variables on individual community choices. We use a combination of a unique micro dataset composed of 90 percent of all homeowners in six school districts in Camden County, New Jersey and information on local community characteristics, including crime rates, commercial activity, and distance from a metropolitan area. Our model implies that all these variables, as well as the local per pupil spending on public education and “community entry prices,” play a major role in explaining the location of individual households. We also calculate and discuss estimates of elasticities of the probabilities of a representative individual choosing a particular community with respect to the various variables.

### **When Can Carbon Abatement Policies Increase Welfare? The Fundamental Role of Distorted Factor Markets**

**Ian W. H. Parry, Robertson C. Williams III, and Lawrence H. Goulder**

NBER Working Paper No. 5967

March 1997

JEL Nos. L51, H23, D52

Public Economics

This paper uses analytical and numerical general equilibrium mod-

els to assess the efficiency impacts of two policies for reducing U.S. carbon emissions — a carbon tax and a carbon quota — taking into account the interactions between these policies and the pre-existing tax distortions in factor markets. We show that tax interactions significantly raise the costs of both policies relative to what they would be in a first-best setting. In addition, we show that these interactions put the carbon quota at a significant efficiency disadvantage relative to the carbon tax: the costs of reducing emissions by 10 percent are more than three times higher under the carbon quota than under the carbon tax. This disadvantage reflects the inability of the quota policy to generate revenue that can be used to reduce pre-existing distortionary taxes.

Indeed, second-best considerations severely limit the potential of a carbon quota to generate overall efficiency gains. Under our central estimates, a non-auctioned carbon quota (or set of grandfathered carbon emissions permits) cannot increase efficiency unless the marginal benefits from avoided future climate change are at least \$25 per ton of carbon abatement. Most estimates of these marginal environmental benefits are well below \$25 per ton. Thus, our analysis suggests that any carbon abatement by way of a non-auctioned quota will reduce efficiency. In contrast, a revenue-neutral carbon tax is found to improve efficiency so long as marginal environmental benefits are positive.

### **Nominal Anchor Exchange Rate Policies as a Domestic Distortion**

**Anne O. Krueger**

NBER Working Paper No. 5968

March 1997

International Finance and  
Macroeconomics

This paper analyzes a nominal anchor exchange rate policy as a domestic distortion, in the tradition of international trade theory. I show that, in addition to the problems of sustainability and exit pinpointed in the exchange rate literature, a nominal anchor exchange rate policy, while in force, drives a wedge between the domestic and the international intertemporal marginal rates of substitution. I then estimate the welfare cost of the Mexican use of the nominal anchor exchange rate policy prior to December 1994.

### **The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment**

**David S. Scharfstein and  
Jeremy C. Stein**

NBER Working Paper No. 5969

March 1997

Corporate Finance

We develop a model that shows how rent-seeking behavior on the part of division managers can subvert the workings of an internal capital market. In an effort to stop rent-seeking, corporate headquarters effectively will be forced into paying bribes to some division managers. And, because headquarters is itself an agent of outside investors, the bribes may take the form not of cash, but rather of preferential capital budgeting allocations. One interesting feature of our model is a kind of "socialism" in internal capital allocation, whereby weaker divisions tend to get subsidized by stronger ones.

### **Returns to Regionalism: An Evaluation of Non-Traditional Gains from RTAs**

**Raquel Fernández**

NBER Working Paper No. 5970

March 1997

JEL Nos. F13, F15

International Trade and Investment

The last decade has witnessed an explosion in the number of regional trade agreements (RTAs). There seems to be a general if ill-defined belief on the part of many policy-makers, and among a number of academics as well, that there is more to an RTA than the traditional gains from trade. I examine several possible benefits that RTAs may confer to their partners, including credibility, signalling, bargaining power, insurance, and coordination. I then assess the necessary conditions for each of these to work; give stylized examples of specific types of policy where they might be applicable; examine real cases where the explanation might be relevant; and discuss their overall plausibility. I conclude by examining NAFTA and the Europe Agreements viewed in this light.

### **A Markup Interpretation of Optimal Rules for Irreversible Investment**

**Avinash Dixit, Robert S. Pindyck,  
and Sigbjørn Sodal**

NBER Working Paper No. 5971

March 1997

JEL Nos. D92, D81, E22

Industrial Organization and Productivity

We re-examine the basic investment problem of deciding when to incur a sunk cost to obtain a stochastically fluctuating benefit. The optimal investment rule satisfies a trade-off between a larger and a later net benefit. We show that this trade-off is closely analogous to the standard trade-off for the pricing decision

of a firm that faces a downward sloping demand curve. We reinterpret the optimal investment rule as a markup formula involving an elasticity that has exactly the same form as the formula for a firm's optimal markup of price over marginal cost. We illustrate this with several examples.

### **The Way We Were (And Are): Changes in Public Finance and Its Textbooks**

**Harvey S. Rosen**

NBER Working Paper No. 5972

March 1997

JEL Nos. H89, B20

Public Economics

This paper uses a comparison of a contemporary public finance textbook with one written in the 1940s as a vehicle for assessing the changes in the field since the beginning of the *National Tax Journal* 50 years ago. The comparison indicates that there have been major changes in the field. From a methodological point of view, the most important change is the embrace of microeconomic theory as the framework for analyzing both positive and normative issues. In addition, the incorporation of econometrics has affected the field dramatically. With respect to topical coverage, research in public finance has changed along with the items on the public policy agenda, and the results of this new research have made their way into contemporary textbooks. But there is continuity as well as change: some topics and their treatments have metamorphosed very little in the last half century.

### **The Demand for Hours of Labor: Direct Evidence from California**

**Daniel S. Hamermesh and Stephen J. Trejo**

NBER Working Paper No. 5973

March 1997

JEL No. J23

Labor Studies

For many years California has required that most women receive time-and-a-half for hours of work beyond eight in a given day. In 1980 this daily overtime penalty was extended to men. This change provides a unique opportunity for estimating the impact of an exogenous increase in the relative price of a marginal hour of labor on the demand for hours of work. Analyzing Current Population Survey data from 1973 and 1985, we find that the overtime penalty substantially reduced the amount of daily overtime worked by California men compared to men in other states and to women in California. Our estimates imply that the price elasticity of demand for overtime hours is at least -0.70.

### **The Forecasting Ability of Correlations Implied in Foreign Exchange Options**

**José M. Campa and P. H. Kevin Chang**

NBER Working Paper No. 5974

March 1997

JEL Nos. F31, G13, G15

Asset Pricing and International Finance and Macroeconomics

This paper evaluates the forecasting accuracy of correlations derived from implied volatilities in dollar-mark, dollar-yen, and mark-yen options from January 1989 to May 1995. As a forecast of realized correlation between the dollar-mark and dollar-yen, we compare implied correlation against three alternative forecasts based on time-series data: historical correlation; RiskMetrics'

exponentially weighted moving average correlation; and correlation estimated using a bivariate GARCH (1,1) model. At the one-month and three-month forecast horizons, we find that implied correlation outperforms these alternative forecasts, often significantly. In combinations, implied correlation always improves the performance of other forecasts incrementally, but the converse is not true; in certain cases, historically based forecasts contribute no incremental information to implied forecasts. The superiority of the implied correlation forecast holds even when forecast errors are weighted by realized variances, reflecting the contribution of correlation to the dollar variance of a multicurrency portfolio.

### **Putting Things in Order: Patterns of Trade Dynamics and Growth**

**Robert C. Feenstra and Andrew K. Rose**

NBER Working Paper No. 5975

March 1997

JEL No. F10

International Finance and Macroeconomics and International Trade and Investment

We develop a procedure to rank-order countries and commodities using disaggregated data on American imports. We find that both countries and commodities can be ranked, consistent with the "product cycle" hypothesis. Countries habitually begin to export goods to the United States according to an ordering; goods also are exported in order. We estimate these orderings using a methodology which takes account of the fact that most goods are not exported by most countries in our sample. Our orderings seem sensible, robust, and intuitive. For instance, our country rankings derived from disaggregated trade data turn out to be highly correlated with macroeconomic phenomena such as national productivity levels and growth rates.

## **Taming the Skew: Higher-Order Moments in Modeling Asset Price Processes in Finance**

**Sanjiv Ranjan Das and  
Rangarajan K. Sundaram**

NBER Working Paper No. 5976

March 1997

Asset Pricing

Many financial markets exhibit a considerably greater degree of kurtosis (and sometimes also skewness) than is consistent with the Geometric Brownian Motion model of Black and Scholes (1973). Among the many alternative models that have been proposed in this context, two have become especially popular in recent years: models of jump-diffusions, and models of stochastic volatility. This paper explores the statistical properties of these models with a view to identifying simple criteria for judging the consistency of either model with data from a given market. Our specific focus is on the patterns of skewness and kurtosis that arise in each case as the length of the interval of observations changes. We find that, regardless of the precise parameterization that we use, these patterns are strikingly similar *within* each class of models, enabling a simple consistency test along the desired lines. As an added bonus, we find that for most parameterizations, the set of possible patterns differs sharply *across* the two models, so that data from a given market will typically not be consistent with both models. However, there exist exceptional parameter configurations under which skewness and kurtosis in the two models exhibit remarkably similar behavior from a qualitative standpoint. The results herein will be useful to empiricists, theorists, and practitioners looking for parsimonious models of asset prices.

## **Banks and Macroeconomic Disturbances under Predetermined Exchange Rates**

**Sebastian Edwards and  
Carlos A. Végh**

NBER Working Paper No. 5977

March 1997

JEL Nos. E3, F31, F41

International Finance and  
Macroeconomics

As the recent Mexican crisis vividly illustrates, Latin American countries often go through boom-bust cycles caused by both domestic policies and external shocks. Such cycles typically are magnified by weak banking systems which intermediate large capital inflows. This paper develops a simple model to analyze how the banking sector affects the propagation of shocks. In particular, we show how the world business cycle and shocks to the banking system affect output and employment through fluctuations in bank credit. We also analyze the countercyclical use of reserve requirements. Evidence for Chile and Mexico supports the main predictions of the model.

## **Openness, Productivity, and Growth: What Do We Really Know?**

**Sebastian Edwards**

NBER Working Paper No. 5978

March 1997

JEL Nos. F13, F43

International Finance and Macro-  
economics and International Trade  
and Investment

For over a century, social analysts have debated the connection between trade policy and economic performance. This controversy continues today, even as the world is experiencing an unprecedented period of trade liberalization, and in spite of numerous studies that claim to find a positive effect of openness

on growth. At the core of these controversies are two issues: first, until recently theoretical models had not been able to link trade policy to faster equilibrium growth. Second, the empirical literature on the subject has been affected by serious data problems. In this paper I use a new comparative dataset for 93 countries to analyze the robustness of the relationship between openness and growth in total factor productivity (TFP). I use nine alternative indexes of trade policy to investigate whether the evidence supports the view that, other things given, TFP growth is faster in more open economies. The regressions that I report are robust with respect to the indicator of openness used, estimation technique, time period, and functional form. They suggest that more open countries indeed have experienced faster productivity growth.

## **Economic Growth and Real Exchange Rate: An Overview of the Balassa- Samuelson Hypothesis in Asia**

**Takatoshi Ito, Peter Isard,  
and Steven Symansky**

NBER Working Paper No. 5979

March 1997

JEL Nos. E31, F31

International Finance and  
Macroeconomics

We test the Balassa-Samuelson hypothesis (that rapid economic growth is accompanied by real exchange rate appreciation because of differential productivity growth between tradable and nontradable sectors) using data on the APEC economies. Japan, Korea, Taiwan and, to a lesser extent, Hong Kong and Singapore, follow the Balassa-Samuelson path. These countries follow a similar pattern of industrialization, increasing the weight of high value-added exports. Although Hong Kong and Singapore grew fast, their

real exchange rates appreciated only moderately. High productivity growth in service sectors might explain this. Other fast-growing ASEAN countries, such as Thailand, Indonesia, and Malaysia did not experience real appreciation. Closer examination of various components of the Balassa-Samuelson hypothesis reveals that key assumptions are not supported uniformly: there is no uniform pattern for the movement of nontradable prices relative to tradable prices, and tradable prices (measured by common currency) do not show international arbitrage.

### **Alternative Strategies for Aggregating Prices in the CPI**

**Matthew D. Shapiro and David W. Wilcox**

NBER Working Paper No. 5980

March 1997

JEL Nos. C82, E31

Economic Fluctuations and Growth, Monetary Economics, and Productivity

The Consumer Price Index does not take into account the fact that consumers alter the composition of their purchases in response to changes in relative prices. This substitution effect causes the CPI to grow faster than the cost of living. We present new estimates showing that this bias in the CPI averaged 0.3 percentage points per year between December 1986 and December 1995. This bias could be eliminated by using a superlative index to aggregate prices across the item-area strata of the CPI. We discuss the practical difficulties in implementing such a calculation and suggest a method for overcoming them. In particular, we show how to construct an accurate approximation to a superlative price index that can be published with the same timeliness as the CPI.

### **The Sugar Institute Learns to Organize Information Exchange**

**David Genesove and Wallace P. Mullin**

NBER Working Paper No. 5981

March 1997

JEL Nos. B00, L13

Industrial Organization

This paper describes information exchange between 1928 and 1936 under the *Sugar Institute*, the trade association of U.S. domestic sugar cane refiners. The Institute collected production and delivery data from individual firms and returned it to them in aggregated form. Attempts to exchange sales data were stymied by the larger firms. Surprisingly, there is no indication of mis-reporting of statistics by Institute members, although, at times, statistics were withheld. The paper concentrates on the evolution of the Institute. Proposals for successor organizations show that a workable mechanism required the central authority to have greater discretion and the larger firms to have greater voting rights.

### **Cellular Telephone, New Products, and the CPI**

**Jerry Hausman**

NBER Working Paper No. 5982

March 1997

Productivity

The cellular telephone is an example of a new product that has significantly affected how Americans live. Since their introduction in 1983, the adoption of cellular telephones has grown at 25–35 percent per year; at year end 1996, about 42 million cellular telephones were in use in the United States. However, the cellular telephone has not been included in the construction of the CPI, and the CPI will not include cellular telephones until 1998 or 1999. This type of neglect of new goods leads to an upward bias in the CPI. This paper

demonstrates that the gains in consumer welfare from a new product such as cellular telephone can be substantial. The paper also gives an approximation result which the BLS could use in the CPI to calculate gains in consumer welfare from new products.

The BLS telecommunications CPI estimates that since 1988, telecommunications prices have increased by 8.5 percent, or an increase of 1.02 percent per year. This estimate ignores cellular service. A corrected telecommunication services cost-of-living index that includes cellular service decreased from 1 in 1988 to 0.903 in 1996, for a decrease of 1.28 percent per year. Thus, the bias in the BLS telecommunications services CPI equals approximately 2.3 percentage points per year. The neglect of new products in the CPI can lead to significant biases.

### **Market Wages and Youth Crime**

**Jeff Grogger**

NBER Working Paper No. 5983

March 1997

JEL Nos. J2, K14

Labor Studies

Youth crime is widespread. To study the effect of market wages on youth crime, I analyze a time-allocation model in which consumers face parametric wages and diminishing marginal returns to crime. Under these assumptions, individuals who work will commit crimes if the returns to the first hour of crime exceed their market wage. This decision rule imposes considerable structure on the econometric model, which I estimate using data from the National Longitudinal Survey Youth Cohort. The empirical model provides estimates of the determinants of criminal returns and of the wage responsiveness of criminal participation. Young men's behavior appears to be very responsive to price incen-



tives. My estimates suggest that falling real wages may have been an important determinant of rising youth crime over the past two decades. Moreover, wages explain an important component of the racial differential in criminal participation, and they largely explain the age distribution of crime.

### **Identifying the Common Component in International Economic Fluctuations**

**Robin L. Lumsdaine and Eswar S. Prasad**

NBER Working Paper No. 5984

April 1997

JEL Nos. E32, C51, E37

Economic Fluctuations and Growth and International Finance and Macroeconomics

We develop an aggregation procedure using time-varying weights for constructing the common component in international economic fluctuations. The methodology for deriving time-varying weights is based on some stylized features of the data documented in the paper. The model allows for a unified treatment of cyclical and seasonal fluctuations and also captures the dynamic propagation of shocks across countries. Based on correlations of individual country fluctuations with the common component, we find evidence for a "world business cycle," as well as for a distinct European common component. We find few systematic differences in international business cycle relationships between the Bretton Woods and the post-Bretton Woods periods.

### **The Technology of Birth: Health Insurance, Medical Interventions, and Infant Health**

**Janet Currie and Jonathan Gruber**

NBER Working Paper No. 5985

April 1997

JEL Nos. I18, I11

Children, Health Care, Labor Studies, and Public Economics

Two key issues for public insurance policy are the effect of insurance status on medical treatment, and the implications of insurance-induced treatment differentials for health outcomes. We address these issues in the context of the treatment of childbirth, using Vital Statistics data on every birth in the United States from 1987–92. We identify the effects of insurance status on treatment and outcomes using the tremendous variation in eligibility for public insurance coverage under the Medicaid program during this period. Among teen mothers and high school dropouts, who largely were uninsured before they became eligible for Medicaid, eligibility meant significant increases in the use of a variety of obstetric procedures. On average, this more intensive treatment was associated with only marginal changes in the health of infants, as measured by neonatal mortality. But the effect of eligibility on neonatal mortality was sizeable among children born to mothers whose closest hospital had a Neonatal Intensive Care Unit, suggesting that insurance-induced increases in use of "high tech" treatments can have real effects on outcomes. Among women with more education, however, there is a countervailing effect on procedure use. Most of these women had private insurance before becoming eligible for Medicaid, and some may have been "crowded out" onto the public program. These women moved from more generous to less

generous insurance coverage of pregnancy and neonatal care. This movement was accompanied by reductions in procedure use without any discernable change in neonatal mortality.

### **The Great Depression and the Regulating State: Federal Government Regulation of Agriculture, 1884–1970**

**Gary D. Libecap**

NBER Working Paper No. 5986

April 1997

Development of the American Economy

The New Deal increased the amount and breadth of agricultural regulation in the economy, shifting it from providing public goods and transfers to controlling supplies and directing government purchases in order to raise prices. It also created the institutional structure to continue the new regulation long after the crisis ended. I classify agricultural laws passed by Congress and the President from 1884 through 1970 as to whether they provided public goods, gave direct and indirect transfers, or engaged in economic regulation. Additionally, I classify laws enacted from 1940 through 1970 as to whether they were linked to specific New Deal agricultural programs. I then test the hypothesis that, absent the Great Depression and New Deal, the pattern of agricultural regulation with public goods and transfers that existed prior to 1933 would have continued through 1970. I assemble and categorize budget appropriations for economic regulation of agricultural commodities as demand enhancement and supply control in order to analyze how the New Deal affected regulatory expenditures relative to what existed prior to 1933. Additionally, I examine staffing and budgets for the U.S. Department of Agriculture and domestic wheat prices to determine if they were

changed by New Deal policies from 1933 through 1970 compared to the pre-New Deal period. Finally, I make international comparisons to determine how the U.S. regulatory experience compared to that in other western industrial countries.

### **The Effect of Managed Care on Health Care Providers**

**Laurence C. Baker and Martin L. Brown**

NBER Working Paper No. 5987

April 1997

JEL No. I1

Health Care

We investigate the effect of managed care on the health care system, focusing on the effect it could have on the number and type of health care providers and their efficiency. By influencing providers, managed care may change the structure and performance of the entire health care system in ways that influence care provided to all patients. We begin by discussing the mechanisms by which managed care influences health care providers, concentrating on shifts in market demand and increases in the amount of attention paid to price in provider choices. We develop a theoretical framework that illustrates these effects. We then empirically examine the relationship between managed care activity and mammography providers. We find that increases in HMO activity are associated with changes in the number of providers, the volume of services produced by each provider, and the prices they charge. This evidence is consistent with the view that HMOs can have broad effects on health care providers.

### **Labor Earnings Mobility and Inequality in the United States and Germany During the Growth Years of the 1980s**

**Richard V. Burkhauser, Douglas Holtz-Eakin, and Stephen E. Rhody**

NBER Working Paper No. 5988

April 1997

JEL Nos. D31, I32, J68

Labor Studies

In recent years there has been increased interest in issues of inequality and mobility in the labor market. Using data from the Panel Study of Income Dynamics and the German Socio-Economic Panel, we compare the labor earnings mobility of prime age men and women in the United States and Germany during the growth years of the 1980s. Despite major differences in labor market institutions, we find very similar patterns in the two countries. Our formal models of labor earnings dynamics suggest a great deal of persistence in both countries. In the United States, this may be the result of permanent individual-specific differences among men, while in Germany random shocks persist longer for men. Women in Germany and the United States have similar earnings dynamics.

### **The Impact of Psychiatric Disorders on Labor Market Outcomes**

**Susan L. Ettner, Richard G. Frank, and Ronald C. Kessler**

NBER Working Paper No. 5989

April 1997

JEL Nos. J24, I12

Health Economics

We use data on 2225 men and 2401 women from the National Comorbidity Survey to examine the impact of psychiatric disorders on employment and on conditional work hours and income. We use two-

stage instrumental variables methods to correct for the potential endogeneity of psychiatric disorders. The instruments used (the psychiatric disorder history of the respondent and the respondent's parents) passed tests of the overidentifying restrictions. Psychiatric disorders significantly reduced employment among both men and women. There was also evidence of small reductions in the conditional work hours of men and a substantial drop in the conditional earnings of both men and women, although these findings were somewhat more sensitive to the estimation methods and specification of the model.

### **U.S. Exports, 1972-94: With State Exports and Other U.S. Data**

**Robert C. Feenstra**

NBER Working Paper No. 5990

April 1997

JEL Nos. F14, C88

International Trade and Investment

This paper describes data on U.S. exports from 1972-94, classified according to the "Schedule B" system, Harmonized System (HS), Standard International Trade Classification (SITC, Revisions 2 and 3), and Standard Industrial Classification (SIC, 1972 basis), along with various concordances. All of these datasets are disaggregated by the destination country for exports. These data are available on the CD-ROM: "NBER Trade Database, Disk 3: U.S. Exports, 1972-94," which can be ordered for \$50 from the Publications Department, NBER, 1050 Massachusetts Avenue, Cambridge, MA 02138. A summary of the SIC data, which does not contain the source country detail and incorporates earlier years, is available via anonymous FTP from [nber.org/pub/feenstra](http://nber.org/pub/feenstra), or via the Web from [www.nber.org](http://www.nber.org). Disk 1 of the NBER Trade Database contained complete data on U.S. imports, and

included on this CD-ROM is a *revision* to the SIC imports for the years 1989–94. In addition, the CD-ROM includes state-level exports and a number of other U.S. datasets contributed by various researchers, such as tariff reductions under NAFTA, antidumping cases, domestic and imported automobile data, materials consumption by industry, foreign trade zones, foreign investment, and programs used to construct and update the data.

### **Are Countries with Official International Restrictions “Liquidity Constrained?”**

**Karen K. Lewis**

NBER Working Paper No. 5991

April 1997

Asset Pricing and International Finance and Macroeconomics

In this paper, I empirically examine consumption smoothing behavior across a broad group of countries using a unique dataset that indicates whether residents in a country face an official government restriction. I then ask whether the *ex ante* consumption movements among restricted countries differ from those among unrestricted countries. To gauge the departure from standard consumption smoothing, I use the Campbell and Mankiw [1989, 1991] approach of regressing consumption growth on income growth and instrumenting with lagged variables. I find that consumption growth for residents in countries that impose international restrictions has a significantly higher coefficient on income growth than consumption growth for residents in countries without those restrictions. Thus, a greater proportion of consumers facing international restrictions appear to act as though they are liquidity constrained according to the Campbell and Mankiw approach. I also discuss alternative interpretations that do not depend on liquidity constraints.

### **Does Acquisition of a GED Lead to More Training, Post-Secondary Education, and Military Service for School Dropouts?**

**Richard J. Murnane, John B. Willett, and Kathryn P. Boudett**

NBER Working Paper No. 5992

April 1997

Labor Studies

This paper uses data from the National Longitudinal Survey of Youth to examine whether acquisition of a GED increases the probability that male and female school dropouts will obtain training, post-secondary education, or military service. We use random-effects-probit models to account for both the dichotomous nature of the dependent variables and the correlations among error terms pertaining to different years of data for the same individual. We find that acquisition of a GED increases the probability that school dropouts obtain post-secondary education and the probability that they obtain noncompany training, defined as training provided by government or by proprietary schools. However, it is still the case that the majority of GED recipients obtain no post-secondary education or training through the age of 26.

### **The Case for a Two-Part Instrument: Presumptive Tax and Environmental Subsidy**

**Don Fullerton and Ann Wolverton**

NBER Working Paper No. 5993

April 1997

JEL Nos. Q21, H23

Public Economics

This paper builds two simple general equilibrium models to demonstrate the equivalence between the Pigovian tax and the combination of a presumptive tax and an environmental subsidy. A presumptive tax is

one that is imposed under the presumption that all production uses a dirty technology, or that all consumption goods become waste. The environmental subsidy then is provided only to the extent that production uses a cleaner technology, or that consumption goods are recycled. To analyze the usefulness of the tax-subsidy combination, we review conceptual considerations regarding its implementation and practical considerations regarding its actual use throughout the world. While the tax-subsidy combination is being used increasingly, in the form of a deposit-refund system, it is important to explore more flexible interpretations. For example, the two parts of such a policy do not have to apply to the same side of the market: the tax and subsidy do not have to be equal, and they can apply to different goods altogether. Compared to the Pigovian tax, a two-part instrument may be easier to enforce and enact, and still can force the market to recognize the social cost of disposal.

### **Business Cycles: Theory, Evidence, and Implications**

**Russell W. Cooper**

NBER Working Paper No. 5994

April 1997

JEL Nos. E32, E37, E44, E62

Economic Fluctuations and Growth

This paper looks at recent advances in the study of aggregate fluctuations. My emphasis is on three prominent areas of research: the stochastic growth model; economies that exhibit macroeconomic complementarities; and models that emphasize heterogeneity. Each section of the paper outlines the theory, discusses relevant empirical evidence, and then discusses some implications of the analysis.

## **The Determinants of Public Education Expenditures: Evidence From the States, 1950–90**

**Raquel Fernández and Richard Rogerson**

NBER Working Paper No. 5995

April 1997

JEL Nos. I22, H52

Public Economics

We examine a panel dataset for the U.S. states over the period 1950–90 and use it to assess the effects of growth in personal income and in the number of students on expenditure on public primary and secondary education. Our analysis suggests that the share of personal income devoted to education is roughly constant, implying that per student education expenditures grow at roughly the same rate as personal income per student. We also find that additional factors accounted for an increase in education expenditures over the period 1950–70.

## **Capital-Market Imperfections and Investment**

**R. Glenn Hubbard**

NBER Working Paper No. 5996

April 1997

JEL Nos. E2, G3, E5, H3

Corporate Finance, Economic Fluctuations and Growth, Monetary Economics, and Public Economics

Over the past decade, a number of researchers have extended conventional models of business fixed investment to incorporate a role for “financial constraints.” This paper reviews this empirical research, and uses advances in models of information and incentive problems to motivate those developments and challenges. First, I describe the analytical underpinnings of models of capital-market imperfections in the investment process, and I illustrate the principal testable implications of

those models. Then I motivate tests and describe and critique existing empirical studies. Third, I consider applications of the underlying models to a range of investment activities, including inventory investment, R and D, employment demand, pricing by imperfectly competitive firms, business formation and survival, and risk management. Fourth, I discuss implications of this research program for analysis of effects of investment on monetary and tax policy. Finally, I examine some potentially fruitful avenues for future research.

## **Sovereign Debt and Consumption Smoothing**

**Herschel I. Grossman and Taejoon Han**

NBER Working Paper No. 5997

April 1997

JEL Nos. F34, H63

Economic Fluctuations and Growth and Monetary Economics

This paper shows that whether a sovereign can borrow to smooth consumption depends both on how the consumption smoothing is achieved — that is, whether by contingent debt issuance or by contingent debt servicing — and on the exact nature of the penalty for debt repudiation. If a sovereign that repudiated its debt could not borrow again, but could continue to save and to dissave, then contingent debt issuance, without contingent debt servicing, cannot support a positive amount of uncollateralized sovereign debt. But, under this same specification of the penalty for repudiation, contingent debt servicing supports a positive amount of uncollateralized sovereign debt.

## **Can Higher Cigarette Taxes Improve Birth Outcomes?**

**William N. Evans and Jeanne S. Ringel**

NBER Working Paper No. 5998

April 1997

JEL Nos. H2, I12, I18

Health Economics and Public Economics

This study uses within-state variation in taxes during 1989–92 to test whether maternal smoking and birth outcomes respond to higher state cigarette taxes. The data come from the Natality Detail files, generating a sample of roughly 10.5 million births. The results indicate that smoking participation declines when excise taxes are increased. The elasticity of demand for cigarettes is estimated to be approximately  $-0.25$ . In addition, estimates of two-part models suggest that taxes only alter the probability that a mother smokes and not her average daily consumption conditional on smoking. Reduced-form models also indicate that higher excise taxes translate into higher birth weights. These two sets of results can be used to form an instrumental variables estimate of the impact of smoking on birth weight. This estimate indicates that maternal smoking reduces average birth weight by 367 grams, which is remarkably close to estimates from random assignment clinical trials.

It is important to note that as a policy tool for improving birth outcomes, cigarette taxes are a blunt instrument. Taxes will be imposed on all smokers, but the benefits received and costs imposed extend beyond the targeted population. Under the naive assumption that the only benefits of the tax are received in the form of improved birth outcomes, we find that an increase in the cigarette tax is not as cost effective in preventing low birth weight as other more targeted public policies, such as the Medicaid expansions of the late 1980s.

## **A Clinical Exploration of Value Creation and Destruction in Acquisitions: Organizational Design, Incentives, and Internal Capital Markets**

**Steven N. Kaplan, Mark L. Mitchell, and Karen H. Wruck**

NBER Working Paper No. 5999

April 1997

Corporate Finance

This paper presents clinically-based studies of two acquisitions that received very different stock market reactions at announcement, one positive and one negative. Despite the differing market reactions, neither acquisition ultimately created value overall. In exploring the reasons for the acquisition outcomes, we rely primarily on interviews with managers and on internally generated performance data. We compare the results of these analyses and analyses of post-acquisition operating and stock price performance traditionally applied to large samples.

We draw two primary conclusions: 1) It is difficult to implement a successful acquisition strategy and to run an effective internal capital market. Post-acquisition difficulties resulted because managers of the acquiring company did not deeply understand the target company at the time of the acquisition; the acquirer imposed an inappropriate organizational design on the target as part of the post-acquisition integration process; and inappropriate management incentives existed at both the top management and division levels. 2) Measures of operating performance used in large sample studies are correlated weakly with actual post-acquisition operating performance.

## **Government Debt and Social Security in a Life-Cycle Economy**

**Mark Gertler**

NBER Working Paper No. 6000

April 1997

JEL Nos. E13, E60

Monetary Economics and Public Economics

This paper develops a tractable overlapping generations model that is useful for analyzing both the short- and long-run impact of fiscal policy and Social Security. It modifies the Blanchard (1985)/Weil (1987) framework to allow for life-cycle behavior by introducing random transition from work to retirement, and then from retirement to death. The transition probabilities may be picked to allow for realistic average lengths of life, work, and retirement. The resulting framework is not appreciably more difficult to analyze than the standard Cass/Koopmans one-sector growth model: besides the capital stock, there is only one additional state variable, the distribution of wealth between workers and retirees. Under reasonable parameter values, government debt and Social Security have significant effects on capital intensity.

## **The History of Annuities in the United States**

**James M. Poterba**

NBER Working Paper No. 6001

April 1997

JEL Nos. G22, D91

Aging, Asset Pricing, Corporate Finance, and Public Economics

This paper summarizes the development of private annuity markets in the United States. Annuities constituted a small share of the U.S. insurance market until the 1930s, when two developments contributed to their growth. First, concerns about the stability of the financial system drove investors to products offered

by insurance companies, which were perceived to be stable institutions. Flexible payment deferred annuities, which permit investors to save and accumulate assets as well as to draw down principal, grew rapidly in this period. Second, the group annuity market for corporate pension plans began to develop in the 1930s. The group annuity market grew more rapidly than the individual annuity market for several decades after World War II. The most recent development in the annuity marketplace has been the rapid expansion of variable annuities. These annuity products combine the investment features of mutual funds with the tax deferral available for life insurance products. Variable annuity premium payments increased by a factor of five in the most recent five years for which data are available.

## **New Evidence on the Money's Worth of Individual Annuities**

**Olivia S. Mitchell, James M. Poterba, and Mark J. Warshawsky**

NBER Working Paper No. 6002

April 1997

JEL Nos. J14, D91, G22, H55

Aging, Asset Pricing, and Public Economics

This paper presents new information on the expected present discounted value of payouts on individual life annuities. We examine the single premium immediate life annuity, an insurance product that pays out a nominal level sum as long as the covered person lives, in exchange for an initial lump-sum premium. This annuity offers protection against the risk of people outliving their savings, given uncertainty about longevity. For reasonable estimates of behavioral parameters, we calculate that individual annuities currently are priced so that retirees without bequest motives should find them of

substantial value in configuring their portfolios to smooth retirement consumption. We also find that the expected present discounted value of payouts, relative to the initial cost of the annuity, has increased over the last decade. These findings bear on the policy debate regarding the role of individual choice and self-reliance in retirement planning.

### **Local Violence, Educational Attainment, and Teacher Pay**

**Jeff Grogger**

NBER Working Paper No. 6003

April 1997

JEL Nos. I2, J1

Labor Studies

Violence in and around schools has drawn increasing attention lately from both the public and policymakers. Despite the importance of the problem, however, there has been limited research on this topic. In this paper I analyze how local violence affects high school graduation, college attendance, and teacher pay. Using data from the High School and Beyond survey, I find that moderate levels of violence reduce the likelihood of high school graduation by 5.1 percentage points on average; lower the likelihood that a student will attend college by 6.9 percentage points; and raise teacher salaries by 2.4 percent.

### **The Optimal Tax Rate for Capital Income is Negative**

**Kenneth L. Judd**

NBER Working Paper No. 6004

April 1997

JEL No. H21

Public Economics

I examine the problem of optimal taxation in a dynamic economy with imperfectly competitive markets. I find that the optimal tax system tends to provide subsidies for the purchase of capital goods in order to offset gaps between price and marginal

cost. The average tax on capital income will be negative, even if pure profits are not taxed away, and even if the alternative distortionary taxes have an *infinite* efficiency cost. These arguments hold even if it is necessary to tax consumption goods which also sell above marginal cost; the difference is that capital goods are intermediate goods and consumption goods are final goods. Since observed markups are greater for equipment than for construction, this analysis justifies the Investment Tax Credit's discrimination in favor of equipment over structures.

### **Industry Evolution and Transition: A Neoclassical Benchmark**

**Andrew Atkeson and Patrick Kehoe**

NBER Working Paper No. 6005

April 1997

JEL Nos. F36, O4, E13

Economic Fluctuations and Growth and International Finance and Macroeconomics

Recently, many countries have undertaken major reforms which have led to a large increase in the number of new enterprises. After these reforms, however, it has taken a number of years before output and productivity have begun to grow. The thesis of this paper is that the process of starting new enterprises is turbulent and time-consuming; as a result, it takes time before the benefits of reform show up in increases in measured output and productivity. To establish a neoclassical benchmark for reforming economies, we ask what the path of transition looks like in an economy with a process governing the growth of new enterprises like that of the United States, that is a well-functioning market economy. We find that it takes 5–7 years until measured output and productivity begin to grow rapidly following reform. This suggests that, even if all other aspects of the economy are

perfect, the transition following economy-wide reforms should take a substantial amount of time.

### **International Trade Between Consumer and Conservationist Countries**

**James Brander and M. Scott Taylor**

NBER Working Paper No. 6006

April 1997

International Trade and Investment

We consider trade between a “consumer” country with an open access renewable resource and a “conservationist” country that regulates resource harvesting to maximize domestic steady-state utility. In what we call the “mild overuse” case, the consumer country exports the resource good and suffers steady-state losses from trade, as suggested by the “conventional wisdom” that weak resource management standards confer a competitive advantage on domestic firms in the resource sector but cause welfare losses. Strikingly, however, when the resource stock is most in jeopardy, the conservationist country exports the resource good in steady state and both countries experience gains from trade.

### **Hot Money**

**V. V. Chari and Patrick Kehoe**

NBER Working Paper No. 6007

April 1997

JEL Nos. F0, F3, G0

International Finance and Macroeconomics

The conventional wisdom is that capital flows between developing and developed countries are more volatile than can be justified by fundamentals. We construct a simple model in which frictions in international financial markets together with occasional fiscal crises lead to excessive volatility of capital flows. The financial market frictions inhibit the transmission of information across investors and lead to herd-like be-

havior. The fiscal crises lead to standard debt-default problems. These crises act as “tests of fire” for borrowing countries. If a country survives such tests, its reputation is enhanced, and future capital flows become less volatile. Failing these tests is associated with a loss of reputation and a decline in the amount of capital flows.

### **Urban Growth**

**Duncan Black and  
Vernon Henderson**

NBER Working Paper No. 6008

April 1997

JEL Nos. O4, R00, E2, J24

Economic Fluctuations and Growth  
and Public Economics

This paper models and examines empirically the evolution of cities in an economy. Twentieth-century evolution in the United States is characterized by parallel growth of cities of different types and ongoing entry of new cities, together maintaining a stable relative size distribution of cities. Each type of city has a particular industrial composition and good(s) it specializes in, and corresponding equilibrium size. We model this evolution in an economy with exogenous population growth and endogenous accumulation of human capital. Within cities, there are knowledge spillovers as well as scale externalities. Individual city sizes increase with human capital accumulation; cities grow in number if national population growth is high enough. Different types of cities grow in parallel in size and human capital accumulation. However, per capita income and human capital levels differ across city types by production process and by the benefits of human investments and spillovers, so there is observed inequality across cities among otherwise identical individuals.

### **Public Goods and Ethnic Divisions**

**Alberto Alesina, Reza Baqir,  
and William Easterly**

NBER Working Paper No. 6009

April 1997

Public Economics

We present a model that links heterogeneity of preferences across ethnic groups in a city to the amount and type of public good the city supplies. We test the implications of the model with three related datasets: U.S. cities, U.S. metropolitan areas, and U.S. urban counties.

We show that productive public goods — education, roads, libraries, sewers, and trash pickup — in U.S. cities (metro areas/urban counties) are related inversely to the city’s (metro area’s/county’s) ethnic fragmentation, even after controlling for other socioeconomic and demographic determinants. Ethnic fragmentation is related negatively to the share of local spending on welfare. The results are driven mainly by observations in which majority whites are reacting to the varying sizes of minority groups. We conclude that ethnic conflict is an important determinant of local public finances.

### **NBER Historical Papers**

#### ***Latifundia* as Malefactor in Economic Development? Scale, Tenancy, and Agriculture on the Pampas, 1880–1914**

**Alan M. Taylor**

NBER Historical Paper No. 96

March 1997

JEL Nos. N56, Q15, Q12

Development of the American Economy

This paper uses extensive micro-level data from Argentine agriculture circa 1880–1914 to explore various hypotheses relating to the supposed unusual and favored position enjoyed by the owner-operated large scale estates (*latifundia*) on the pam-

pas, as compared to small-scale units operated by cash tenants and sharecroppers. I have access to several datasets which allow me to explore whether tenancy and scale mattered as determinants of technique and efficiency in the rural estates of Buenos Aires province at the turn of the century. I obtain some surprising results. Tenants did not seem disadvantaged in terms of access to land. Accumulation of land in and of itself produced no direct gain in terms of augmented land prices (caused by say, scale economies or monopoly power). And tenancy status appears to have mattered very little as a determinant of investment choices. I conclude that the case against the *latifundia*, and the pessimistic conventional view of tenant farming on the pampas, rests at present on little solid quantitative evidence.

#### **Debt, Default, and Revenue Structure: The American State Debt Crisis in the Early 1840s**

**Arthur Grinath, III; John Joseph  
Wallis, and Richard Sylla**

NBER Historical Paper No. 97

March 1997

JEL Nos. N21, N41, N71

Development of the American Economy

During the 1820s and 1830s, American state governments made large investments in canals, banks, and railroads. In the early 1840s, nine states defaulted on their debts, four ultimately repudiated all or part of their debts, and three went through substantial renegotiations. This paper examines how the states got into the debt crisis and, as a result of their earlier history, how they responded to fiscal pressure in the debt crisis. The explanation is built around revenue structures. States along the developed eastern seaboard were able to avoid politically costly property taxes, while states along the frontier were forced to rely heavily on property taxes. When faced with

fiscal pressures, two of the defaulting states — Maryland and Pennsylvania — were able to resume debt payments, with back interest, as soon as a property tax was enacted. The other defaulting states, however, already had high property taxes. Without access to new revenue sources, these states were forced to default, and then either to renegotiate or repudiate their debts.

### **Inventors, Firms, and the Market for Technology: U.S. Manufacturing in the Late Nineteenth and Early Twentieth Centuries**

**Naomi R. Lamoreaux and Kenneth L. Sokoloff**

NBER Historical Paper No. 98

April 1997

JEL Nos. O3, N0, L0

Development of the American Economy

Recent scholarly literature explains the spread of in-house research laboratories during the early twentieth century by pointing to the information problems involved in contracting for technology. We argue, by contrast, that these difficulties have been overemphasized; in fact, a substantial trade in patented inventions developed over the course of the nineteenth century, much of it taking the form of transactions conducted at arms-length through the market. This expansion of trade in technology made possible a growing division of labor, as inventors increasingly took advantage of their greater ability to sell off rights to patented technologies and focused their energies and resources on invention itself. Firms in turn responded to the expansion of this trade by developing capabilities that enabled them to learn about and assess externally generated inventions. Although it is true that by the early twentieth century large firms also were beginning to invest in developing their internal inventive capabilities, in doing so they faced a number of significant problems. Most

importantly, they had to overcome resistance to contracts requiring employees to sign over patents to their employers, and they had to reduce the high turnover rates that made such requirements effectively unenforceable. The increased costs of inventive activity and the greater risks borne by independent inventors by the early twentieth century helped firms to make their case. But there was still a lot of organizational learning involved. Hence where other scholars have emphasized the difficulties of contracting for technology in the market and the relative ease of integrating invention and production within the firm, we reverse the story. Economic actors at that time had a great deal of experience contracting for new technological ideas in the market; what they did not know how to do, and had to spend a great deal of time and energy learning, was managing creative individuals within the firm.

### **NBER Technical Papers**

#### **The Significance of the Market Portfolio**

**Stefano Athanasoulis and Robert J. Shiller**

NBER Technical Working Paper No. 209

February 1997

JEL Nos. G00, G13, G22

Asset Pricing

The market portfolio in one sense is the least important portfolio to provide to investors. In a J-agent-one-period-stochastic-endowment economy, where preferences are quadratic, a social-welfare-minded contract designer would never create a contract that would allow trading the market portfolio. Even the complete set of contracts, all J-1 of them, which provide a first best solution, never span the market portfolio. These conclusions rely on the assumption that the contract designer has perfect information about agents' utilities. We also show that as the

contract designer's information about agents' utilities becomes less perfect, optimal contracts eventually become contracts that weight individual endowments in proportion to elements of eigenvectors of the variance matrix of endowments. Then, if there is a strong enough market component to endowments, a portfolio approximating the market portfolio may be the most important portfolio.

### **Observational Agency and Supply-Side Econometrics**

**Tomas Philipson**

NBER Technical Working Paper No. 210

February 1997

Health Care

A central problem in applied empirical work is separating out the patterns in the data that are attributable to poor production of the data, such as non-response and measurement errors, from the patterns attributable to the economic phenomena studied. This paper interprets this inference problem as an agency problem in the market for observations, and suggests ways in which using incentives may be useful in overcoming it. I discuss how wage discrimination may be used to identify economic parameters of interest, taking into account the responses in the survey supplied by sample members to that discrimination. Random wage discrimination alters the supply behavior of sample members across the same types of populations in terms of outcomes, and thereby allows for separating out poor supply from the population parameters of economic interest. Empirical evidence for a survey of U.S. physicians suggests that survey supply even for this wealthy group is affected by the types of wage discrimination schemes discussed, in a manner that makes the schemes useful for identification purposes. Using such schemes to correct mean estimates of physician earnings increases those earnings by about one third.



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