Economic Interstate Conflict: The World Trade Organization
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FREE TRADE

Scholars and international political economy experts have offered a variety of explanations for why trade disputes have continued and even increased despite the World Trade Organization’s best efforts to deter and resolve them. Page 18

CONSUMER BEHAVIOR

Consumers are turning to products that possess premium quality yet are relatively more accessible to the masses than traditional luxury goods. These so-called “new luxury goods” are refreshing the market with their distinct character that makes them so emotionally attractive to the consumer. Page 8

THE VISIBLE HAND

SPRING 2005

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DEVELOPMENT Auto-makers from Detroit and Stuttgart continue to pour in billions of dollars into building new plants and training staff in China. The automobile market has seen impressive growth in recent years and the potential seems to be enormous. But is the growth sustainable? Are the international auto giants’ moves into the market too abrupt? Page 41

MACROECONOMIC POLICY Several years of rapid growth caused by trade imbalances have absorbed the initial slack that existed in many Asian countries. However, if left unchecked, large external deficits combined with overheating of an unsustainable economy will expose these countries to external shocks and political unrest. Page 38
From the Editor:

“I would found an institution where any person can find instruction in any study.”

- Ezra Cornell, 1865

Now, while our benefactor and namesake’s goal was laudable, it’s kind of like saying that Abercrombie and Fitch is an equal opportunity employer. Any study? Really? Ok, so we all know and love Economics, but let’s see, does Cornell offer Animal Science? Check. Science of Earth Systems? Yep, we’ve got that too. How about Textiles and Apparel? Amazingly enough, future Ralph Laurens and Donna Karans can find what they’re looking for in the College of Human Ecology. We even have a curiously named “Special Programs” major, as well as the best school of hotel management in the country. It seems that “any study” isn’t all that far from the truth!

But, can “any person” truly find instruction at Cornell? Not exactly. Unlike “open universities” like the University of Phoenix and Podunk U, the gates of Cornell are controlled by the fine people at the admissions office. Of course, if you’d like a building named after you, I’m sure that an exception could be made. However, there is an additional financial barrier to cross as well. With tuition alone in the “endowed” colleges currently running at thirty-thousand dollars a year, by the time we graduate some of us will be paying down the equivalent of a small mortgage for our Cornell education.

And herein lies my point. Not just Cornellians, but Americans as a whole are sliding into dangerous levels of debt. According to a recent article in Forbes by A. Gary Schilling, the national savings rate has dropped from 12% in the early 1980’s to virtually nothing today. And our penchant for spending extends to our government too, with the national debt approaching almost 8 trillion dollars! To put that in perspective, every man, woman, and child would have to pay the government more than $26,000 dollars each to cover the debt.

However, Joe Average hasn’t been the one footing the bill for our national debt… yet. Instead, enormous consumer demand for imported goods has led to a massive trade deficit. In exchange for the inventory of a typical Wal-Mart, countries such as China have collected vast reserves of US dollars, which are then reinvested into the United States as treasury bonds. Effectively, our foreign trading partners buy our national debt. The big question is whether the current situation is sustainable, which is not a question easily answered.

And on that inconclusive note, I’d like to take this time to thank all the writers, editors, and sponsors who make The Visible Hand possible! I would also like to encourage anyone interested in writing about economics or working with an enthusiastic editorial team to join us next semester as we begin work on the Fall 2005 issue. For more information, check out our website at [groups.yahoo.com/group/visiblehand] or subscribe to our listserv by sending an email to [visiblehand-subscribe@yahoogroups.com]. With that, I would like to welcome you to the Spring 2005 issue of The Visible Hand!

Best,
Michael Tang

Our Mission

1. To raise economic, political, and social awareness amongst Cornellians of our roles as citizens of the global community.

2. To address and analyze current news-worthy events while promoting further inquiry into how they fit within a historical context, as a link between our past and the possible realities of our future.
The Recent Surge in Mergers and Acquisitions

By: Linda R. Pedersen

There seems to have been a consolidation surge in many different industries recently, involving widely discussed merger and acquisition deals ranging from market sectors such as telecommunications to the personal care industry. Why do firms choose to merge, and who are the stakeholders in these M&A deals? Do the interests of the firms’ management and their shareholders conflict, or is consolidation to the benefit of everyone? How does consolidation affect the performance of the firms involved and the competitors in the firms’ industry? These are all questions that need to be answered in order to reveal the true benefits and costs of mergers and acquisitions.

The Mechanics of M&A

Consulting a Financial Economics textbook (Brealey, Myers & Marcus, 2004), I was able to acquire a general overview of the mechanics of mergers and acquisitions. This textbook on Corporate Finance identifies three ways for a company to acquire another company:

1. Merge the two companies into one. The acquirer will take over all of the assets and liabilities of the acquired company, and the acquired firm will in effect disappear, with its shareholders receiving stock from the acquirer or cashing out.

2. A tender offer in which an outside company attempts to buy another company’s stock through its shareholders rather than its management, and can thereby take control over the firms’ management.

3. Acquiring the other company by purchasing the firm’s assets directly rather than through the shareholders.

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Despite these three major ways of acquiring another company, the overwhelming trend in the recent high-profile mergers and acquisitions such as the P&G and Gillette merger seem to have favored option #1 above. As long as the potential merger is thought to improve the firm’s standing in the market and thereby increase shareholder value, it should be in the shareholders’ best interest to encourage the merger.

Merger Types

With such a distinctive trend of consolidation in various different industries, there must be some clear benefits to derive from M&A. Mergers can be classified as three distinctive types, each with presumably different motives and benefits:

1. Horizontal mergers, involving two former competitors in the same industry.
2. Vertical mergers, involving companies who operate at different stages of the production process.
3. Conglomerate mergers, involving companies in completely different industries.

"The mergers might satisfy Wall Street, but they'll hurt Main Street"

Why Merge?

Why do firms find it profitable to merge with former competitors? The most obvious explanation for this is the potential for economies of scale. The fixed costs of the company can be decreased by spreading them over a large volume of output, especially in such aspects as back-office operations and computer systems (Brealey et al., 2004). However, large companies engaging in horizontal mergers do need to be aware of the potential for anti-trust legislation due to the decreased competitiveness of the market in their industry as a result of their consolidation. Companies may also incur wrath from consumers, who may be forced to pay more and have less choices due to the decreased market competitiveness. For example, the Consumers Union is currently criticizing the potential MCI and Verizon merger as hurting telecommunications customers. According to a policy advocate for the Consumers Union, Kenneth DeGraff, "The mergers might satisfy Wall Street, but they'll hurt Main Street" (Cheng, 2005).

Additionally, there are several problems that may arise as a result of two companies merging together which need to be taken into account when analyzing the potential costs and benefits of an M&A deal, such as different corporate cultures perhaps not being compatible. The recent dismissal of former Hewlett-Packard CEO Carly Fiorina demonstrates the potential for unsatisfactory results from merging two giant companies, in her case Hewlett-Packard and Compaq back in 2002 (Berman & Latour, 2005). However, horizontal mergers in general do have a greater success-rate than other types of mergers, and for example the P&G and Gillette merger does stand to reap from the benefits of cost-rationalization (The Economist, 2005).

Who Benefits from a Merger?

From a shareholder’s perspective, it may be desirable to be a shareholder of the company that is being taken over. To use the P&G and Gillette merger as a recent example, Gillette shares increased by 13% when it was confirmed that P&G was willing to offer $52.4 billion for Gillette (Zuckerman, 2005). However, there has been recent speculation about who really benefits from a company merger. Calpers, the largest public pension fund in the country, has released a statement questioning whether advice to shareholders from investment banks involved in the merger may be biased, and in that way push through M&A deals that may not be beneficial for shareholder value and may result in a large number of layoffs, while benefiting top
management and the investment banks (Davis, 2005).

An article in the The Wall Street Journal, “No Razor Here: Gillette Chief to get Giant Payday,” similarly questions who stands to lose and who will inevitably benefit from company mergers (Maremont, 2005). According to the article, Mr. Kilts, Gillette's chairman and chief executive, may earn more than $153 million from the deal, while more than 6,000 P&G and Gillette employees are estimated to get laid off as a result of the merger. As an article in The Wall Street Journal claims “One of the best ways to take advantage of the return of the big deals is to buy shares of the only companies sure to see a payoff from it all -- the investment banks that get paid big sums to negotiate the deals ” (Zuckerman, 2005). Regardless of the motives behind M&A deals and how they will affect stakeholders, it is apparent that further consolidation is the wave of the future in a wide variety of industries.

Who Will Be Next?

As a result of the recent P&G and Gillette merger, it is likely that we will experience more consolidation in the personal care industry. Similarly, the SBC and AT&T deal clearly triggered further consolidation in telecommunications, as the current merger discussions between MCI and Verizon, and MCI and Quest demonstrate. It is a general trend that once an industry experiences a merger of that size, the competitiveness of the market will be changed in such a way that competitors will find it in their best interest to merge as well (Zuckerman, 2005).

Other industries that are thought to be consolidating further in the future include the financial services industry, due to the large number of American banks and the competitiveness of the industry, and the pharmaceutical industry, which has a number of companies looking to spend their money (Zuckerman, 2005). Additionally, another major trend for the future may be an increase in cross-border deals. The closer integration of the European market as a result of the recent EU expansion and other legislation specifically targeting cross-border deals should provide such a trend in the future. American companies with operations abroad also stand to benefit from cross-border mergers, as acquiring a local company will enhance their local knowledge and presence in that region (Cauchi, 2005).

Although it is clearly too early to say whether the recent giant P&G and Gillette, and SBC Communications and AT&T deals were successful and beneficial to the various stakeholders of the firms, these deals are representative of what we should expect to see in the future. Mergers will continue to be highly debated phenomena, with interest groups representing consumers arguing that consumers are being hurt in the process, while firms and their management argue that they will be better able to serve the needs of the market. Regardless, further consolidation is the clear trend in virtually all industries of the economy, and it is therefore a question of how soon, not if, the next giant merger deal will occur.

References:


New Luxury: 
Like It or Spike It?

By: Olivia Liang

Being spun off by its parent company, Sara Lee, marked the beginning of robust growth for Coach Inc. The New York-based leather goods and accessories retailer has more than doubled its net sales and increased its net income by more than six-folds in the four years following its initial public offering in 2000 (Coach, 2004). With its unique market positioning that targets the middle-income consumers (especially females), Coach is aggressively grabbing the market share from traditional luxury retailers such as Louis Vuitton and Burberry. The phenomenal growth of Coach is a reflection of the rapidly changing taste among American consumers nowadays. As more and more American consumers are capable of affording a higher premium for all kinds of products, they are not only focusing on the functionality and reliability of the products but also the experiential and emotional components. In particular, the consumers are turning to products that possess premium quality yet are relatively more accessible for the mass consumers.

Who are demanding new luxury goods?

The emergence of new luxury goods has been no accident. Multiple factors have contributed to consumers’ changing need and taste, germinating a series of products that combines the premium quality of a traditional luxury with a refreshing consumption experience. Several of the more important factors are the constant income growth throughout the past decades, the increasing active role that females play in the household and the workplace, and the dramatic changes in lifestyle among the baby boomer generation and the younger generation.

The steady growth in real income level, particularly in the 1990s, has boosted the growth in consumption among American households. According to the household income report released by U.S. Census Bureau in 2004, 73.2% of American households had an annual income of $54,500 or above in 2003 (Current Population Survey 2003 and 2004, Annual Social and Economic Supplements 2004). The real median income has climbed from $33,000 in 1967 to $43,400 in 2003 (in 2003 dollar). As a greater proportion of the population enters the middle income market, these people are dominating society’s economic trends.

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aggregate purchasing power. Moreover, these middle-income households’ wealth is growing at a much faster rate than their consumption, leaving these households approximately $3.5 trillion disposable income sitting in their bank account waiting to be spent. The implication for business owners is enormous: most of the products available in the existing market merely fulfill consumers’ basic needs and fail to address new needs of the increasingly demanding consumers or create needs for them. An under-addressed purchasing potential passes by the market without inspiring much innovation or creativity in companies.

The second factor—the increasingly active role that females play in the household and the workplace—is visible through the comparison between female’s historical and current income. If one decomposes the aggregate real income growth by ethnicity or gender, one would find that the increase in female’s income becomes progressively significant. Female workers, especially full-time workers, whose real income almost doubled in the past four decades, have boosted the female-male earning ratio up to 76:100 from 61:100 in 1960 (Current Population Survey 1961 to 2003, Annual Social and Economic Supplements 2003). Accompanying females’ higher participation rate in the work force is the postponement of marriage by an average of four years and a higher divorce rate (U.S. Adults Postponing Marriage 2001). The postponement of marriage results in a large population of young singles who are more likely to spend money on themselves and to polish their self-image with affordable premium products. The same story applies to a higher divorce rate as well. In a new single state, people tend to increase consumption to alleviate the negative emotional impact that the divorce has on them and perhaps, to seek new partners (Fiske and Silverstein 2003). This changing consumption pattern is particularly typical of women, who tend to express their emotions more openly than men. This indicates that the middle-income women are searching for not only premium products that breaks out of the box of traditional luxury goods, but also goods that they can emotionally relate to.

In addition, the middle-income baby boomers, who have the strongest purchasing power in the society now, are craving for ideas and products that reveal more undiscovered needs on which they can spend their no-where-to-spend spare cash. Data shows that the 75 million baby boomers are controlling $1 trillion disposable income every year yet are directly targeted by only 10% of advertisements (Davis 2005). Not only do baby boomers have a large store of disposable income, they also actively explore products that can add more spice to their lifestyle as they are free of a child-rearing burden and are mostly heading toward retirement. According to a consumer confidence survey report released by the market research firm AC Nielsen in 2004, American consumers spend 23% of their spare income (defined as the income left after consumers cover essential living expenses) on out-of-home entertainment, 21% on new clothes, and 20% on home improvements, making almost half of their spare income (Consumer Confidence Survey 2nd Half 2004). With baby boomers’ unique needs and strong purchasing power, this particular under-targeted consumer segment is another critical factor that catalyzes the surge of new luxury goods.

...virtually every new luxury brand/product carries a unique message and targets different consumer segments...

Why new luxury goods?

By now I have discussed who is demanding new luxury goods and why, but this is still not sufficient to explain why middle-income consumers are streaming into Crate&Barrel or Pottery Barn instead of Wal-Mart for home necessities, or why women are carrying a Coach handbag instead of the latest LV logo bag. What is so attractive about the new luxury goods? This is the question that I will try to answer in this section. Although virtually every new luxury brand/product carries a unique message and targets different consumer segments within the middle-income consumers, their marketing strategies are not much different from each other. The first step in understanding the secret of these new luxury goods is to understand their market positioning, in another word, the message that they want the consumers to receive.

Create or emphasize an unfulfilled need for customers and help them satisfy this need—this is the essential component in every successful marketing recipe. Marketers for new
...the emotional and personal element in a product is becoming an increasingly crucial factor that influences purchasing decisions. benefits.

luxury goods follow the same golden rule with no exception. The previous section of this article suggests that the emotional and personal element in a product is becoming an increasingly crucial factor that influences purchasing decisions. Consumers start to recognize the importance of the consumption experience surrounding a certain product, and thus, are willing to pay more for a product that provides them with such an experience than for a product that merely satisfies daily necessity. This particular consumption experience was once quite exclusive to the super-premium products, which in fact charge the consumers a huge premium for the excellent service. Recognizing this desire for a personalized shopping and consumption experience, the marketers for new luxury products equip their products with a series of pre-and post-purchase services that corresponds with the value positioning of the product. For example, Crate & Barrel always conducts extensive site selection before the opening of each branch store. The design of each store has to match with the community that the store situates. The lighting and the music within each store are specifically chosen to create a soothing shopping environment that makes the customers want to linger. Each product conveys not only its functional value but also a unique lifestyle and a pleasurable shopping experience. And this experiential component of the products is precisely what the consumers are willing to pay a premium for. By targeting this unfulfilled need in the middle-income market, the new luxury goods successfully dominate this consumer segment with high purchasing potential.

Providing a distinctive shopping experience, however, is not at all a new idea to the market. This is in fact what most of the super-premium brands have relied on for their survival. The marketers for new luxury goods need to differentiate their products from the traditional luxury goods by responding to the consumption pattern of this particular consumer segment. The target consumers of new luxury goods—the middle-income consumers—occupy the gap between the mass market and the “class” market. Although these consumers may not be financially capable of being a frequent customer at Prada, they do have the preference for an affordable premium product over conventional products. As long as their financial ability permits, these middle-income consumers are perfectly willing to pay a 20% to 200% premium for near-the-top products—in another word, to trade up in a certain product category. Knowing this consumption pattern, the marketers for new luxury goods position their products with the “class to mass” philosophy in mind. On one hand, since consumers often use prices as an indicator of quality, the marketers price their products at or near the top of the product category to distinguish the product’s premium quality from conventional products in the market. On the other hand, marketers ensure the quality and reliability of their products are consistent and comparable to those of the super-premium products. By providing an equally high-quality product at a slightly lower price, the marketers prove their products to be a “better deal” for consumers. For example, Urban Outfitters, Inc., a retail company that specializes in merchandising lifestyle products ranging from clothing to home accessories, has been growing robustly in recent years by catering “culturally sophisticated and self-expressive” image to the younger generation (Urban Outfitters, Inc. Form 10K 2003). One of its brands, Anthropologie, which targets upscale urban females in their thirties and forties, started off its business with 7 stores in 1993 and has now expanded to 40 retail stores covering North America (Ibid). It provides a full line of lifestyle products that are relatively high-priced yet are more affordable than some of the
other more upscale luxury brands. The brand consistently puts a huge amount of effort into crafting a visually and emotionally pleasing and eye-catching catalog, which helped boosting both its in-store and online sales as well as unambiguously conveying its brand image. By differentiating itself with a stylish yet urbane lifestyle it promotes, Anthropologie now accounts for 44% of Urban Outfitters’ net sales (Ibid). Anthropologie’s rapid growth captures the increasingly challenging demand from modern consumers, especially female consumers. The affordable premium price of the new luxury goods represents a better deal for middle-income consumers; while the high quality of the products corresponds with these consumers’ desire to “trade up” in the product category.

In summary, providing a consumption experience that was previously inaccessible to most middle-income consumers are what is most appealing about new luxury goods. Brands that are traditionally characterized as middle-market players, such as Coach, are capitalizing on this craving for a compromise of quality and price. Moreover, many traditional luxury brands, such as BMW, are extending their product line to embrace this emerging market. And other relatively more conventional products, such as Oil of Olay, are moving up the category in an effort to scoop a share of this huge market.

The Future of New Luxury Goods

One may tend to think of the existing new luxury goods as a temporary alternative for the middle-income consumers who cannot afford the super-premium brands yet. It may seem that they will eventually trade up to the top of the category as their income accumulates. Thus, the ultimate winner of the competition is still the traditional luxury goods. This could very well be true, and it is certainly one of the challenges facing the entire new luxury goods market. But here is the good news for the marketers for new luxury goods:

Consumers’ taste is plastic and constantly changing. Just as the new luxury products are differentiating themselves from the traditional luxury products by prices, they could very well achieve this goal by changing the consumers’ taste. The secret recipe to success is the same for both new and traditional luxury products—to capture the unfulfilled needs among consumers and address them with innovative product features. A new luxury brand could very well be the market leader once it controls the rule of a particular product category. Coach is already turning this possibility into reality in Japan by rapidly catching up with the No. 1 seller in Japan, Louis Vuitton. Perhaps we are not far away from the day where every woman is tugging a handbag with symmetric C’s under her arm.

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New Luxury: Like It or Spike It?
The Common Agricultural Policy and Struggling International Agricultural Economies

By: Katherine DeWitt

The Common Agricultural Policy in the European Union has many international consequences. Many of these are detrimental, such as the consequences of its variable tariffs on imports, as well as the change in EU position in agricultural markets due to increased green technology.

The business of farming is treated with specific economic analysis in most countries. Rural communities are seen as refreshing escapes from the city professionalism of starch black suits and crunching numbers. A farm brings to mind the picturesque scene of expansive fields and the preservation of traditional values. It was with this mindset that the Common Agricultural Policy (CAP) was established in 1962 (Baldwin & Wyplosz, 2004). The CAP allows European Union (EU) countries to guarantee EU farmers high, stable prices for their goods through domestic price support and import tariffs. However, prosperity at home for the EU occurs with the cost of depressing the economies of agricultural countries in South and Central America. By simultaneously decreasing quantities of EU imports and increasing quantities of EU exports into the world market, the CAP depresses the world price of agricultural products. This leaves the major agriculture producers, the Cairns countries, to absorb the negative shocks of the CAP.

The objective of the CAP in the 1960s was to protect EU farmers by providing high and stable prices for agricultural goods which, in turn, would materialize into a stable income for farmers. The Treaty of Rome (article 39) states one objective of the CAP is “to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earning of persons engaged in agriculture; to stabilize markets.” By making farming more profitable, the EU strived to maintain the existence of rural communities and traditional values while easing urban congestion. The CAP also set forth to address environmental concerns as well as technical efficiency in hopes of the EU becoming competitive in the international agricultural market. The CAP garnered support because after WWII, policies which offered price and income security were a welcomed intervention from the volatile times of the past.

The two primary mechanisms created and utilized by the CAP are domestic price support through a price floor and the imposition of tariffs on imports. In practice, this means a minimum price floor of 50%-100% above world prices is set in the EU with the guarantee that any products not sold at this price will be bought by the EU (Baldwin & Wyplosz, 2004). In addition, as one of the largest agricultural importers, the EU also levies tariffs on imports to ensure that lower world prices will not negatively affect local producers by running their higher priced goods out of the market. In theory, this special treatment of agricultural products will bring an “even closer union among the peoples of Europe,” (Baldwin & Wyplosz, 2004). In the 1950s the agricultural sector constituted a significant fraction of those people, about one in five living on farms at the time (Baldwin & Wyplosz, 2004).

Unfortunately, the largest agricultural economies outside the EU, called the Cairns group, are also the poorest countries (Baldwin & Wyplosz, 2004). These countries include Argentina, Bolivia,
The Common Agricultural Policy

Brazil, Chile, Colombia, and Costa Rica among others. The CAP greatly affected their economies with regard to both imports and exports. First, the EU regulates trade by charging these countries variable tariffs to import their goods into the EU. These variable tariffs precipitate the depression of the world price and instability of the economies of poor countries.

In order to maintain a fixed price for agricultural goods imported into the EU, the CAP established variable tariffs on exporting-non EU countries. The imposition of an import tariff translates to reduced exports out of poor countries, since they now have to pay a fee for each good imported into the EU in order to ensure a constant, high EU price. However, this tariff cannot itself be constant because crop output depends on many environmental and economic factors. For example, in a year with plenty of sun, poor country farmers may have a better crop than the previous year, therefore naturally increasing supply. However, in order to maintain a constant EU price an increase in natural supply simply means that because more goods are available, price decreases and the tariff representing the difference between the world price and EU price increases.

This variable tariff has multiple effects. First, it makes the economy of the Cairns countries very volatile, which negatively affects their financial planning and investments. In addition, the real price the country receives for exports during an increased output season is reduced, as a larger portion of it merely pays the import tariff. Also, with a fixed price for imports the quantity of exports out of the South and Central American countries falls. Therefore less quantity is sold at a lower real price, reducing revenue.

Decreasing exports leads to a depression of the world price. The result of decreased exports bought by the EU is an increased supply of agricultural goods within Cairns countries. However, the demand for food is fairly inelastic because there is an upper limit on the amount one person can consume. Basic economic analysis explains that as supply increases and demand remains fairly constant, the price of goods must decrease in the Cairns countries. Therefore, the world price of goods produced is depressed, leaving poor countries with less revenue from their products.

The depression of world prices only worsened once the CAP continued and the importing position of the EU radically changed. During the 1960s post-war period, just as the CAP was instated, a rapid growth in the EU technology of pesticides, fertilizers, and farm machinery occurred, called the “Green Revolution” (Baldwin & Wyplosz, 2004). This greatly increased the success and productivity of EU farmers. This production growth led to drastically increased domestic supply of agricultural products.

Prior to the Green Revolution, the supply of EU farm goods at the CAP guaranteed price floor was less than the demand, meaning the EU imported goods from Cairns countries. However, after the Green Revolution, and due to increased production capacity, supply of EU farm good increased, while demand and price remained constant. Therefore, at the price floor, supply was greater than demand and the EU became an exporter. However, since the CAP price was necessarily higher than the world price, in order to export goods the EU had to sell excess goods at the world price and pay EU traders subsidies equal to the world price minus the CAP price guarantee. This “exporting of goods at a price that is below cost,” is called dumping (Baldwin & Wyplosz, 2004). Dumping EU goods back into the world market created a greater supply of agricultural products in the world market, including poor countries. Therefore, economics dictates that increased supply with constant or decreased demand results in decreased world prices.

The Green Revolution and price stability of CAP reduced the EU demand for imports from Cairns Group countries because home production increased. Eventually, as the EU farm industry thrived, it became a net exporter and the supply of exports onto the world market increased. These changes erode both the price Cairns countries receive for their exports, as well as the quantity they are able to export into the EU. World price and export quantity have been depressed by the CAP, leading to lost profits for poor agricultural economies.

In addition to the economic depression of poor countries, the CAP influences the United States, which also subsidizes exports. EU exports under CAP policies create excess supply in the world and depress world price. Therefore, the U.S. then has to pay more in order to subsidize the increased difference between the lower world price and its exporting threshold.

Clearly, the CAP has encountered its share of problems. In the 1980s, the problems forced new EU members Spain and Portugal to ally with existing members, Greece and Ireland. They advocated the allocation of structural funds to countries like themselves that contributed to the EU budget but did not have suitable farmland and therefore saw no returns. In addition, in 1990 the Cairns group threatened to walk-out of all trade agreements when the EU refused to liberalize agricultural trading. These actions finally resulted in reforms in 1994 in the Uruguay Round which made tariffs fixed as well as mandated that the EU allow 5% of domestic demand be fulfilled by imports (Baldwin & Wyplosz, 2004). These reforms affected the international community by reducing dumping, resulting in a slight increase in world price and therefore increased revenue for agricultural countries.

The CAP intended to stabilize prices and incomes within the EU farming sector. It resulted in exactly the opposite in poor agricultural economies. Variable tariffs reduced the amount and price at which countries could afford to export, which decreased revenue. This increased supply in poor countries, lowered world price and further depressed revenue. As the EU agricultural sector flourished during the Green Revolution, the dumping of excess exports into the world economy further increased supply. This again decreased world price and revenue in poor countries. Overall, the CAP set out to protect farmers at home, yet in practice it depressed world price and revenue for poor agricultural countries in the world market.

References:

Financial Integration: A Road Towards Growth or to Increased Vulnerability and Poverty?

by: Madhurima Bhattacharyay

The devastating impact of the 1997 financial crisis on several East Asian countries raised the important question: should developing nations open their financial systems to global capital flows?

Over the last decade, many developing countries have become increasingly integrated into global financial markets. Financial integration usually refers to financial openness or a country’s linkages to international financial markets and is associated with policies on capital account liberalization (the extent of government restriction on capital flows across the border) and actual capital flows. It is a process by which separated financial markets become connected, open, and unified so that all the market players have full and free access of the integrated markets. It can be achieved through deregulation, liberalization, and privatization of the market. Liberalization of the capital account is a key step towards openness. This allows the market players, consumers, and investors free and full access to all markets to acquire different kind of financial products, risk management methods, and investment and portfolio diversification facilities.

In theory, financial integration or financial globalization assists in supplying and allocating capital, fostering economic growth and in reducing macroeconomic volatility, and in increasing standard of living or welfare overall. It does this by developing (i) an effective financial sector- through increased international portfolio flows resulting in improved liquidity of domestic stock markets and increased foreign bank participation that facilitates access to international financial markets, introduces new financial products and techniques and assist in strengthening the regulation and supervision of domestic banks, (ii) enlarging the supply of savings through foreign direct investment, (iii) lowering the cost of capital through better allocation of risk, increasing risk management systems through improved risk-sharing and (iv) helping to transfer modern technology and skills (managerial know-how) from outside of the country as a result of foreign direct investment in domestic firms.

Financial integration usually is achieved by reducing restrictions on capital flows and allowing markets to set prices of currencies and securities. The resultant increase in international capital flows to developing countries is the results of both “pull” and “push” factors. Liberalization of capital accounts and domestic stock markets and privatization of state-owned banks and firms are the “pull” factors. On the other hand, business cycle conditions and macroeconomic policy changes in developed countries are the “push factors”. The benefit of integration includes rise in capital flows across markets and in the long run returns and prices of the traded financial products converge in common currency terms.

The devastating impact of the 1997 financial crisis on several East Asian countries and 1994-95 Mexican crisis raised the important question: should developing nations open their financial systems to global capital flows? To answer this question, one needs to examine empirical data to assess whether financial integration fosters economic growth for developing countries or leads to increased vulnerability and poverty.

In 1997 and 1998, sudden outflows of capital from several East
Asian countries with open financial markets sparked a plunge in their currencies, stocks and other assets and severely damaged some of their financial institutions. Economies contracted and the standards of living of millions of people worsened. Economic development was set back for years in some areas. The Asian financial crisis has demonstrated how financial integration could expose developing counties to external shock. These shocks reversed the success in poverty reduction in some countries from openness of the financial markets and caused a significant increase in poverty in the short to medium term.

Countries become more vulnerable to financial crises and accompanying increases in poverty in the early stages of financial integration.

A recent IMF study by Prasad et. al (2003) concludes that countries need to build effective financial institutions and put in place sound economic and regulatory policies before they integrate their financial systems and liberalize their capital accounts. The empirical analysis does not show that financial integration enhanced economic growth for developing countries. Countries with pegged exchange rates, poorly supervised financial markets and weak macroeconomic policies will face more frequent and deeper crises if they link into global markets without first making radical changes, the study says. Prasad indicates that though it may appear that better financially integrated developing countries have attained a higher per capita income than others, a systematic examination of the evidence does not appear to show a strong causal relationship between the degree of financial integration and output growth performance. On the contrary, evidence suggests that the process of capital account liberalization, in some cases, appears to have been accompanied by increased vulnerability to crises. As a response to the cause behind this increased susceptibility, Prasad reasons that “Globalization has heightened these risks since cross-country financial linkages amplify the effects of various shocks and transmit them more quickly across national borders.”

With respect to benefits of increasing growth and reducing macroeconomic volatility, the IMF study concludes that “Development of an effective financial sector and institutions is a crucial prerequisite for delivering the benefits or preventing a country’s vulnerability to crisis. Developing countries can benefit significantly from financial integration with the world economy [only if] their economic polices are good. Countries with a pegged exchange rate regime, unsound domestic macroeconomic policies and poorly supervised financial markets will face more frequent crises and deeper depressions”.

What is the impact of financial integration on poverty? A separate study by Agenor (World Bank, 2002 and 2003) says countries become more vulnerable to financial crises and accompanying increases in poverty in the early stages of financial integration. They achieve the greatest benefits after integration reaches a certain stage. Beyond a certain threshold, integration brings with it, or induces governments to implement far-reaching domestic institutional reforms that improve savings and investment, strengthen the financial system and improve the social and legal infrastructure to encourage greater risk taking.

According to Agenor, international financial integration leads to several benefits such as risk sharing for consumption smoothing, increased investment through capital flows, and growth through greater efficiency and stability of financial systems; however, he acknowledges that there are several risks associated with it as well. These risks include a high degree of concentration of capital flows/lack of access to capital for small countries, inadequate domestic allocation of capital flows, loss of macro stability; volatility of capital flows, risks with foreign bank penetration, and procyclical movements in short term capital flows. The foreign banks may cause credit rationing to small and medium size firms, particularly in nontradable sector, and increased concentration of allocation of credit that may increase income inequality.

In the case of small open
developing countries, the benefits of financial integration are mostly long term in nature; whereas the risks associated with it can be significant in the short term. For instance, poverty at first tends to increase when financial globalization rises from low to moderate levels; however, it declines once globalization increases beyond a certain point. Therefore, Aegnor concludes that “Globalization may hurt the poor in some countries not because it went too far but rather because it did not go far enough. Beyond a certain threshold, a greater degree of real and financial integration brings with it (or induces governments to implement) far-reaching domestic institutional reforms that improve savings and investment, strengthen the financial system, and improve the social and legal infrastructure conducive to greater risk taking”.

According to a study by Baldacci et. al. (2002), the 1994-95 Mexican financial crisis gave rise to an increase in poverty and some cases, income inequality. The incidence of poverty as defined poverty head count ratio increased by around 6% to reach 17% in 1996 from 10.6% in 1994, reversing the reduction in poverty made between 1992 and 1994. Adequate social safety nets for households should be in place prior to the integration of domestic financial markets.

These studies suggest that sudden financial integration without sound economic policies and adequate absorptive capacity, flexible exchange rate, effective institutions and good governance, particularly well supervised financial markets can increase vulnerability to crises, recession and increased poverty. On the other hand, if the financial sector is well developed and supervised, a proper exchange rate policy is in place and institutions are strengthened prior to financial openness, it can minimize the adverse effects of increased vulnerability to crisis and maximize its benefits in terms of growth and welfare. To have a positive impact on poverty through higher economic growth and lower instability, countries should continue with the process of financial integration until substantial progress is achieved and a certain threshold, with respect to the soundness of their domestic monetary and fiscal policies and the quality of their social and economic institutions, has been surpassed.

References:


The Role of Economics in the Origins of the Civil War

By: Adam Sasiadek

In contemporary academic discussions of the causes of the Civil War, American students will very likely hear about the role of slavery (and the need to end it), the necessity of preserving the Union, and other sociological and political factors. Those are undoubtedly valid and important reasons and are thus appropriate to classroom discourse on this topic. Unfortunately, however, very little focus is ever given to the role of the economic forces that contributed to the climate that led to the conflict. Understanding the economic underpinnings behind these developments will allow us, as Americans, to delve deeper into the origin and impact of a historical event that still greatly interests us and that remains the focus of much discussion and debate.

Economics played a tremendous role in fomenting an atmosphere of deep animosity between the North and South during the antebellum period, and the central economic issue driving this ongoing disagreement was the protective tariff. The Constitution had originally prohibited any form of direct taxation, such as the income tax, but it did allow for the federal government to generate revenue through “duties, imposts, and excises,” as stated in Article I, Section 8, a provision which the Founding Fathers applied through the tariff. Even at that time, however, the ideological division that would reach its destructive fruition in the Civil War was already apparent—that between the Hamiltonians and the Jeffersonians.

Alexander Hamilton supported an economic system of centralized, Federal government intervention (albeit interventions on a diminutive scale, relative to today’s economic situation), which involved the use of policies such as the protective tariff, monetary inflation through a centralized banking system, a Federal land policy, and corporate subsidies, policies that were later championed by the Whig Party (the party that Abraham Lincoln, coincidentally, belonged to). Thomas Jefferson, on the other hand, and those who would continue his intellectual/political tradition (primarily the Democratic Party), opposed these initiatives of economic intervention, favoring instead a much smaller role for the state, a free banking system, and free trade (or at least revenue tariff as opposed to the protectionist tariff), all operating within a decentralized economic/political framework. It should be remembered, however, as economists Mark Thornton and Robert Ekelund (2004) point out in their book, Tariffs, Blockades, and Inflation: The Economics of the Civil War, there were some northern free traders and southern protectionists, but it can be safely generalized that by the 1850s, the North was mostly protectionist/Hamiltonian, while the South was pro-free trade and Jeffersonian in outlook.

The economic development of each region played a role in these disagreements over policy, with the industrialized northern states supporting the protective tariffs for industries such as steel, and the dominantly agrarian South depending upon access to international markets to sell its cash crops like tobacco and cotton, and therefore favoring free trade (DiLorenzo, 2003). Throughout most of the 19th century, starting with the Clay Tariff of 1824, a protectionist tariff policy was in place to some extent, and this situation clearly benefited the North at the expense of the South. As economist Thomas DiLorenzo has pointed out (2004), “Since Southern farmers sold some three-fourths of what they produced on world markets, they simply had to eat the costs of tariffs, and were unable to raise their prices to any significant extent in

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response to the higher tariff rates that made clothing, farm tools, and machinery, and many other manufactured items more expensive.” The tariffs therefore inflicted economic damage not only on consumers, but on exporters as well, who were unable to pass on the costs of the tariff due to the competitive pressures of the world market. To view the tax situation another way, the South was paying 75% of the nation’s federal taxes, while most of the federal government’s expenditures were in the Northern states. This clearly unjust situation was a major factor in the South’s animosity toward the North (Adams, 2001). The North, meanwhile, becoming ever more dependent upon manufacturing, would become ever-more supportive of a protective tariff and thus be placed in a political boiling point by 1860. The average tariff rate during the 1850s had been at a historical low for the 19th century, 15%, but then the Morrill Tariff was passed in March, 1861, shortly before Abraham Lincoln entered office, which raised the average rate to 47%, and expanded the range of goods to which it applied. It was named after Congressman Justin Morrill, a steel manufacturer from Vermont, the same person who also sponsored the Morrill Land-Grant College Act of 1862, and in whose honor Cornell’s Morrill Hall is named (being that Cornell benefited from the Act). While the South had been able to exert its influence against the tariff earlier in the century, when South Carolina nullified the Tariff of 1828 (the “Tariff of Abominations”), forcing President Andrew Jackson to back down from his support of the bill and allowing for the rates to be gradually reduced, it was unable to do so in 1861, and the Morrill Tariff was passed with overwhelming Northern support and equally strong Southern opposition (DiLorenzo, 2003).

Abraham Lincoln, a supporter of the tariff, centralized banking, and the other aspects of the Whig economic platform, was essentially the “political heir” of Alexander Hamilton (DiLorenzo, 2002), and in his March 4, 1861 inaugural address declared that “The power confided in me will be used to hold, occupy, and possess the property, and places belonging to the government, and to collect the duties and imposts; but beyond what may be necessary for these objects, there will be no invasion – no using force against, or among the people anywhere” (DiLorenzo, 2002). He was not going to back down on the tariff issue the way Jackson did—either the duties would be collected, or there would be an “invasion”—war. The South had long felt cheated by the tariff system, and wanted only further reductions in the rates. For the Republicans to triple the average taxation rate for Southerners through the Morrill Tariff and to then vigorously enforce the new law without compromise gave the South few options for a just remedy (or at least that is how they probably perceived the situation). As DiLorenzo notes, “Several Southern states had already seceded, including South Carolina, that past December, when it was apparent that the tariff would probably pass the Senate and would be enforced by Lincoln, the career-long protectionist. Again, this is not to say that the tariff was the sole cause of the war, but it was certainly relevant (2002). The South soon acted upon one of those options. On April 12, 1861, the tariff collection center of Charleston Harbor, Fort Sumter, was attacked by the Confederates. Indeed, economic considerations, particularly the tariff, played an important role in dividing the North and the South and in the events that lead to the South’s secession.

The Civil War took the lives of 600,000 American men (the equivalent for today’s population would be five million) and had a tremendous impact on the political and social course that our nation would take, its repercussions lasting to this day. Understanding the economic causes behind this event will give us a more complete historical picture of how and why it was fought at all. Economic analysis is vitally important in our interpretation and understanding of political events, yet its power is often ignored or given little emphasis, unfortunately. Hopefully this article will allow its readers to keep this in mind, so that they will always remember to examine the economic aspect behind historical and contemporary political issues.

References
Economic Interstate Conflict: The World Trade Organization and Dispute Settlement – Evaluating Schools of Thought

By: Neelu Toor

Carl von Clausewitz, the renowned theorist of war, wrote that war is politics conducted by other means; today, the same could be said for law (Esserman & Howse, 2003). Disputes that previously were settled by negotiation or force of arms are now taken to international courts, tribunals, and arbitral panels - legal briefs are proliferating to replace diplomatic notes (Esserman & Howse, 2003). Since 1995, trade disputes, in particular, have exploded in number, compared to the pre-World Trade Organization era under the General Agreement on Tariffs and Trade (GATT). Under the 48 years of the GATT, there were 101 disputes brought to trial; contrastingly, in the 10 years of the WTO, 328 disputes have been brought to the WTO’s Dispute Settlement Board (DSB) (WTO, 2005).

Scholars and international political economy experts have offered a variety of explanations for why trade disputes have continued and even increased despite the World Trade Organization’s best efforts to deter and resolve them. The literature on exactly why disputes increase and continue is underdeveloped and limited, but there is information available on why countries choose to violate agreed upon rules, and what causes trade disputes to arise. By examining this literature it is possible to extrapolate the causes of trade disputes to address the question of why the disputes have continued and even increased.

Changes in the International Economy: Globalization School of Thought

Since the advent of the WTO in 1995, vast changes in the international trading regime have occurred as the world has globalized: international financial institutions play an increasingly important role in interstate relations, the demand for services and products from around the world have gone up, and new borders have opened. With globalization, the jurisdiction of the WTO has expanded to cover sectors that were not included in the GATT. In addition, global trade has increased, and new markets and developing countries have liberalized and grown. At first glance, scholars often offer up these three changes as explanations for why trade disputes have increased.

Expansion of WTO Jurisdiction

Before the WTO, the GATT was seen as the main authority governing international trade laws and relations. From 1947 to 1995, there were 101 disputes brought to the GATT for resolution, averaging approximately two disputes per year and including only developed countries (WTO, 2005). The WTO has recently witnessed a major jump in disputes: between 1995 and 2005, there have been 328 disputes brought to the DSB, averaging 32.8 disputes per year (WTO, 2005).

To explain this dramatic increase in disputes, scholars first point to the fact that the governance of the WTO has expanded to areas not covered by the GATT, such as agricultural policies and intellectual property rights (WTO, 2005). Others claim that the expanded rules that arose during the creation of the WTO have led to the increase in disputes because the rules are now stricter (Yin & Doowon, 2001).

However, with the expansion of authority over certain sectors, the WTO also expanded its ability to deter violations of rules. The Dispute Settlement Procedure (DSP) granted the WTO the ability to allow nations to seek compensation and retaliation if they ruled
that agreements were violated. Therefore, one would assume that despite the increase over areas that could be ruled, the number of disputes would decrease, or that it would at least offset the number of disputes because of the deterrent from the system. Yet, this has not been the case. Empirically, the number of disputes has increased, countries continue to choose to violate rules, and other countries continue to question and demand justice when those violations are deemed to have occurred.

Increase in Global Trade

Certain scholars point to the growing levels of international commerce as the basis for the rise in trade disputes (Stein, 2001). Therefore, they claim that the increasing number of disputes is simply the result of expanding world trade (Yin & Doowon, 2001). This makes sense insofar as trade disputes presuppose trade; that is, trade disputes do not arise between nations that do not trade with one another (Yin & Doowon, 2001). For the purposes of this analysis, the trade that is of concern is that between members of the WTO who have the ability to bring conflicts to the DSB. Therefore, in order for this sub-school of thought to be accurate, trade would have to first increase among member nations for trade disputes to also increase.

However, when examining the ten-year history of the WTO, peculiarities arise regarding the proportion of trade and the number of disputes. Although total disputes have increased since 1995, the first five years of the WTO saw more disputes taken to arbitration than the last five years (Yin & Doowon, 2001). Even though trade has increased, within the first five years of the WTO, when 180 of the 328 disputes were brought to the DSB, the major complainants and defendants were developed countries, nations that had already actively been engaged in world trade and in various sectors for some time (Yin & Doowon, 2001). It is in the last five years that new members have been admitted to the WTO, and since then, the number of disputes has not been as high (Yin & Doowon, 2001).

Thus, the critical implication is that trade disputes presuppose trade, and if the argument is that increases in trade cause increases in disputes, then based on membership, the last five years should have seen more disputes than between 1995-2000, which, empirically, is not the case (Stein, 2001). Also, it might seem self-evident that the more trade a country conducts, the more conflicts and friction it is likely to encounter, but there are exceptions. For example, India was the 22nd largest country in terms of trade volume, but it was ranked the 4th largest country in terms of the number of disputes in which it was involved (Yin & Doowon, 2001).

Emerging Markets and Developing Countries’ Involvement

As aforementioned, trade disputes do not arise between countries that do not trade, and despite the fact that the overall number of disputes have decreased slightly since new members have joined the WTO, the number of disputes brought forth by developing countries with emerging markets has actually increased (WTO, 2005).

Developing markets are becoming key players in the world economy as their trade activity has increased

This year alone, the three disputes brought forth have been from developing countries—Mexico, Chile and Pakistan (WTO, 2005). Under the WTO, about half of all disputes include developing countries as either the complaining party or respondent, compared to only one quarter being involved under the GATT (WTO, 2005). Previously, smaller countries may have worried that the support/benefit of maintaining an amicable relationship with a powerful country would be compromised by litigating against them. As a result, developing nations were less likely to make use of the DSP, but since the beginning of the Doha round of trade talks, developing countries have started taking a stand for themselves (Chang, 2002). Instead of making the usual concessions to developed nations like the United States and the European Union, developing countries have been refusing to accept trade barriers and have been demanding changes be made to trade imbalances.

Therefore, even though disputes have declined since 2000, the number of disputes concerning developing countries has risen, and this is commonly given as an explanation for the increase and for the continued rates of trade disputes. While this explanation is adequate for explaining the trend in the last five years, it still does not describe why levels have been so high over the last ten years. Even within the last five years, this sub-school only accounts for half of the trade disputes. Moreover, as much as developing countries might increasingly be the defendants in trials, many countries still lack the resources and capacity to bring trade conflicts against developed countries to the DSB.

Conflicting Norms and Conflicts of Law: Trade Barriers School of Thought

As history has shown, trade relationships embody and generate conflict. Initially, political conflicts over trade emerged when countries had to renegotiate tariff reduction agreements and other barriers to trade (Stein, 2001). Since the GATT,
many tariff barriers have been lowered, and under the WTO, non-tariff barriers (NTB) have proliferated.

Conflicts emerge over issues such as standards barriers, subsidies, intellectual property rights violations, dumping, discriminatory domestic taxes, government procurement, and measures related to investment (Yin & Doowon, 2001). The conflicts over the array of incongruent domestic practices, which result in trade disputes, can be divided into two categories: trade barriers caused by influences from national sectors (certain industries and lobbyists) and trade barriers that arise from national ideals and principles (attitudes towards certain products) (Yin & Doowon, 2001).

NTB and other modes of unwillingness to adhere to WTO rules pose barriers for trade since they prevent other countries from exporting and also limit imports (Yin & Doowon, 2001). These barriers to trade are a result of conflicting norms and the desire to protect domestic industries and interests. According to this school of thought, the political inability to comply is basically the prime reason why states do not comply with rules they initially agreed to (Esserman & Howse, 2003). Therefore, nations choose to violate rules and seek retribution for those violations due to conflicts between legal systems and slow internalization of the relevant international norms (Esserman & Howse, 2003).

**Sectoral Influences**

Countries want to protect their domestic interests, and leaders of countries want to appease their constituents. As a result, the roles of certain powerful domestic sectors with self-interested economic motives influence a country’s international trade policy. These interests are reflected both in the violation of agreed-upon rules and the desire of countries to take certain issues to litigation.

Countries are influenced in a variety of ways by representatives of various sectors, but the size and the importance of an industry to a certain demographic of the population forms the group of representatives. The European Union and the United States are arguably the WTO Members who are most influenced by domestic NGOs, lobbying, civil society and public opinion through channels like television, the internet and democratic politics (Esserman & Howse, 2003). In terms of traditional power politics, these groups are, in a sense, the negotiating “weaknesses” of these two powerful players (Esserman & Howse, 2003). It is these sectoral influences that sometimes force states to engage in activities that will most undoubtedly provoke retribution or incite states to pursue retribution against another state.

The content of clashes over sectoral interests often concerns conflicts of national laws. Each country has its own tax code, and some provisions of those tax codes tend to favor certain industries or certain companies that engage in international trade. Low-interest loans, government guarantees, export assistance, tax credits or special tax treatment for engaging in certain export activities are prevalent in certain countries. Such actions tend to provoke conflicts (Yin & Doowon, 2001).

Most trade conflicts occur in commodities where regulation support programs and quality and health standards are significant aspects of the market structure (Yin & Doowon, 2001). The persistence of national subsidies also comprises a large portion of trade disputes; in fact, ongoing disputes over subsidies that violate existing WTO rules have led to the largest amount of authorized retaliation in WTO history (Bagwell & Staiger, 2004). The specific industries that have the greatest influence on pressuring their governments to violate rules or go after other countries for violating rules are agriculture, electronics, steel and businesses dealing with intellectual property rights (Bagwell & Staiger, 2004).

This sub-school does a good job of explaining why a country may choose to violate WTO rules despite the disincentives. An actual study of cases brought to trial also supports the claims that certain domestic rules are the cause of conflict and that it is the conflict over national laws that cause trade barriers, which in turn result in trade disputes. Nevertheless, the desire to protect domestic industries is not a new one in international trade; indeed, many countries have a legacy of protectionism. Therefore, this is not a unique explanation of why trade disputes have increased in the post-GATT era. Of course, it is true that the GATT did not have jurisdiction over agriculture and intellectual property rights over which the WTO does. Despite this, the majority of trade disputes, when examined by issue, have been over antidumping measures that cover a greater variety of industries than those traditionally protected by sectoral influences (WTO, 2005).

**National Ideals**

As with sectoral influences, which are based on clear-cut economic interests, national ideals and principles also influence a country’s international trade policies but are instead based on shared national norms and mores. Health, labor and environmental policy concerns, in combination with perceptions of what the law is or should be, play an important role in creating the type of political pressure that constrains a country’s policy choices (Esserman & Howse, 2003).

There are a growing number of trade disputes over product standards (Strum, 2001). When importing items from certain nations, human rights issues are a concern; when accepting certain plants or animals into a country, regulations are a consideration; and when trading drugs, health standards are questioned. Every country has its own sets of norms and beliefs, and these are reflected in their trade policies, both in the items they are willing to export and import. When a country refuses to accept an item, trade disputes often arise.

In most cases, the disputed policy regulates a product, the consumption of which causes local damages and infringes upon national norms of what are acceptable products. For example, consider the case of hormones: both political and societal
pressure within the European Union to retain some form of ban on meat produced with growth hormones seem to stem, at least partly, from the European Union’s ideological opposition to the trade item (Strum, 2001).

These trade disputes over national product standards are a growing source of tension in the international trading system and are cited as one of the main reasons for the increase in the number of disputes (Strum, 2001). What happens in certain cases is that a country introduces a new product standard for all sales of a good in its local market, which is justified as necessary for consumer or environmental protection. Importers into the local market, however, challenge the standard as a “disguised barrier to trade” or “green protectionism” (Strum, 2001).

As with the “sectoral influences” sub-school of thought, this one also explains the reason behind trade disputes as a result of countries’ violating WTO rules or seeking retribution because of domestic influences. The political inability to comply is the primary reason why states do not comply with rules they initially agreed to. Also, the sources of empirical evidence, this sub-school cannot adequately be relied upon to explain the increase in trade disputes.

Why Have Trade Disputes Increased?

On the whole, these schools of thought seem implausible as adequately being able to explain the increase in trade disputes. However, two schools stand out as being interrelated and important in analyzing the cause of and increase in trade disputes: the emergence of new markets and conflicting norms and laws.

As mentioned, the conflicts over norms and laws are not new barriers to trade. The difference now compared to before is that there were fewer main players in the pre-WTO international trading world. However, within the last ten years, emerging markets and developing countries are starting to play a greater role in international trade. They are starting to retaliate, and the older and more powerful players, like the United States and the European Union, are facing the consequences. Therefore, despite the fact that within the last five years trade disputes have fallen slightly overall, developing nations are becoming more active in bringing conflicts forward. Even though trade is increasing and borders are opening, certain countries are clinging to their old trading norms in the interest of domestic politics, and as a result, are facing conflicts of law as the barriers to trade are no longer being left unquestioned.

Therefore, the increase in trade disputes may be partially explained by the increase in developing markets having the capacity and initiative to respond to violations against them, and partially by the persistence of trade barriers attributable to conflicting cross-border norms and laws. A closer look at the recent WTO ruling on the Brazil cotton case could show exactly how a developing market had the capacity to win against the US over a prominent trade barrier. Thus, while this paper presents a review of current ideas about the cause of trade disputes, further research may help shed new light on the mechanisms that are at work.

References:


Privatization of Social Security

By: Jerry Shih

Privatization of Social Security has been a heated topic of discussion in America. With the impending retirement of the so-called Baby Boomer generation (born between the mid-1940s and the mid-1960s) in 2008, the public has begun to worry about the ability of the current Social Security system to sustain such a great demand of retirement benefits. Despite a positive balance in the Social Security Trust Fund, by 2015 Social Security will be paying more in benefits than it collects in taxes, and by 2039 the Trust Fund will be depleted (Figure 1-1, Board of Trustees, 2000).

The aims of this article are (1) to examine the problems within the current Social Security system, (2) to analyze the claims by the proponents of a Social Security under privatization, and finally (3) to determine whether privatization will solve the imminent fiscal imbalance.

We first examine the basic structure and components of the current Social Security system. The Social Security program was created in 1935 in response to the Great Depression. Its main purpose was to ensure a secure source of income for the elderly who had been impoverished by the depression. Several modifications were subsequently made to the program. In 1939, Social Security included survivor benefits to the spouses and children of covered workers. In 1956, it provided disability insurance to disadvantaged workers under the system. Therefore, the Social Security program is also known as OASDI (Old, Age, Survivor, and Disability Insurance).

The extension of coverage to those over age sixty-five in 1939 established the system in a PAYGO (Pay-As-You-Go) framework, where retirees live on the income of current workers. Instead of an accumulated fund,
If tax rates and benefit structure remain constant, Social Security will be unable to pay promised benefits.

Payments for each generation of retirees are made by the current generation of workers. The PAYGO element in the system not only enables risks to be shared across different generations, but also transfers income among individuals, leading to the enactment of Supplemental Security Income in 1972. SSI provides a nationwide minimum income guarantee for the aged, blind, and disabled. Such distributive features of Social Security raised much controversy, which we will discuss in a later part of the article.

The system is financed by the payroll tax. As benefits have grown, so have payroll tax rates (Office of the Chief Actuary, Social Security Administration). The Social Security Amendment in 1983 arranged surpluses from Social Security to be accumulated in Social Security Trust Fund. Any surplus—resulting from payroll tax revenue exceeding payments to beneficiaries—is transferred to the Social Security Trust Fund and is statutorily required to be invested in Treasury securities.

The main problems faced by the current Social Security system are the long-term fiscal stresses on it. Projections of Social Security finances under current rules suggest that the system will be paying out more benefits than collecting contributions by 2012, and will enter financial insolvency by the year 2012 (Table IV.B1, 2001 OASDI Trustees’ Report).

If tax rates and benefit structure remain constant, Social Security will be unable to pay promised benefits. Different options have been suggested to solve the imminent fiscal imbalance. A reduction in benefits and an increase in contribution will solve the problem in the short-term. One proposal is to reduce the benefits by indexing the Normal Retirement Age (NRA), the age at which an individual qualifies for full Social Security retirement benefits, to life expectancy. With the advance of medical treatments, life expectancy has increased dramatically; and an increase in life expectancy raises the cost of Social Security. The government can solve the fiscal imbalance in a short run by raising the NRA. The NRA is 66 for individuals born between 1944 and 1954. It then increases by two months per year, reaching 67 for workers born in 1960s or later. Yet, the legislation did not change the minimum age of 62 for claiming retired worker benefits. Thus, changes in the NRA in turn change the bases used to calculate the retirement benefits in different benefit formulas for people who delay their retirement (after the NRA) and for people who retire early (before the NRA). There will be a permanent reduction in the benefits for people retiring at 62—the benefit they receive will be 70% of the Primary Insurance Amount instead of 80% (Diamond, 1996).

However, as suggested by Altig and Gokhale, such a policy will likely face several obstacles. A significant benefit cut will alleviate the situation temporarily at the cost of people in or near their retirement. People approaching their retirement expect a major part of their income after retirement coming from Social Security benefit. With a cut in their benefit, their living standards will be jeopardized (Altig, 1997).

Privatization brings light to such a time of turbulences. Two main arguments made by the proponents of privatization are that a privatized Social Security will increase national saving, and by investing the Trust Fund in private
equities, the higher rate of return might alleviate the fiscal pressure on the system.

As stated earlier, the expansion of PAYGO enables risks to be shared across generations and transfers income among individuals. Retirees who live on Social Security do not receive their income from their contribution to the system. Instead, they are supported by the income of current working generation. Thus, the current working force is not paying for their benefits in the future but for others in retirement. It is known as a defined-benefit system where you work for a certain amount of time and devote your labor to the economy, and you obtain pensions when you retire. Furthermore, the system also distributes income within set age groups, from higher earnings to lower earnings. The higher the individual’s income, the smaller the individual’s gain from Social Security (Table 9.3, Rosen, 1999).

Such intergenerational and intra-generational resource transfer is considered a major cause of the decline in the United States’ national savings, because it discourages the current working class’s incentive to save (Gokhale, 1996).

Privatizing Social Security will change the system from defined-benefit to defined-contribution, where you contribute your earnings to an actual account—Personal Retirement Account—from which you will obtain your income during retirement. Defined-contribution will increase people’s incentive to save because how much you save determines how much you will get after you retire. Saving accounts such as the IRA and the Roth IRA in the United States are set up similarly in order to encourage people’s incentive to save.

Moreover, privatization will increase people’s incentive to work. The closer the link between contribution and benefits, the smaller the labor-supply distortion and the efficiency losses (Diamond, 1977; Kotlikoff, 1995). Privatization can increase these linkages by different means, such as removing the adjustment of the NRA (Mitchell, 1996).

However, privatization does not guarantee higher national saving, and might even discourage people’s incentive to save. Whether national saving increases depends on the income and substitution effect. Privatization increases the reward on saving, thereby making saving more attractive to people. However, privatization also creates an income effect, where one needs to save less to achieve any level of future consumption (Mariger, 1997). Which is the stronger effect depends on individual preferences. The result is thus ambiguous.

Another argument made by the proponents of privatization is that by investing the Trust Fund in equity markets, the government will receive a higher return and thereby solve the impending fiscal imbalance. Instead of purchasing Treasury securities, funds in the Trust Fund will be used to purchase private assets. The returns obtained from private assets will be paid out as benefits. Historically, the return on stocks exceeds the return on Treasury bonds (Miron, 2001). Thus, it appears that investing in private assets will improve the Trust Fund’s solvency without any unnecessary reforms such as raising payroll taxes or extending the NRA. If the government can successfully exploit the disparity in the rates of return between Treasury bonds and equity markets, insolvency should supposedly be eliminated.

Yet, it has to be noted that a higher return from private assets comes with a higher risk. It is possible that stocks, instead of increasing returns, will put individuals into financial risk. Furthermore, privatization will encourage individuals to borrow to invest in equities, thereby increasing the demand of assets. With an ambiguous result in the amount of national saving, such an increase in asset demand merely “reshuffles” the claims to capital income without increasing the funds for retirement consumption (Mariger, 1997). Thus, it does not solve the fiscal problem that Social Security faces.

In addition, there are also some downfalls to a privatized Social Security. The current Social Security forces people to save. Without a Social Security run by the government, saving might decline. People might not save enough to support their retirement consumption needs.

Furthermore, administrative costs of the current Social Security system are only one-fourth of those under a private pension system (Reid, 1995). Transition from the current Social Security to a privatized one necessitates additional costs, increasing the national costs.
debt. If the system is privatized, older generations still need to be included in the current Social Security while younger generations are under a privatized Social Security. There will be a gap between benefits payouts and revenues collected, which will probably be closed by creating additional public debt. Thus, there will be a sizable increase in fiscal deficits to finance benefits payments to older generations (Kotlikoff, 1996).

More importantly, Social Security is not just a retirement system. It is also a social insurance for individuals who experience unexpected trauma. Incorporating disable individuals in Social Security enables them to receive full benefits until their retirement age, at which point they become covered by the retirement plan. Privatizing Social Security eliminates such benefits for the disabled and thereby makes them worse off. Furthermore, Social Security drastically reduces the poverty rate among the elderly. Compared to the overall poverty rate of 12 percent in the United States, the poverty rate for the elderly is 10 percent. Without Social Security, the poverty rate for the elderly would be about 50 percent (Apfel, 1998). Thus, Social Security plays a crucial role in reducing poverty among the elderly.

Unfortunately, the privatization of Social Security is not as ideal as its proponents claim to be. Whether it will increase national saving depends on the income and substitution effect’s impact on individual saving behavior, which varies due to different individual preferences. In addition, because of the ambiguous outcome in national savings, it is difficult to determine whether there will be a higher return from investing in private assets. Instead of exposing retirement incomes to risks in stocks, the government could achieve the same result in a safer way—raising payroll taxes or cutting benefits. In addition, privatizing Social Security will eliminate the redistributive property and will thereby increase the poverty rate among the elderly and deprive the disabled of a significant source of support.

The future of Social Security will depend on what the government expects the system to achieve. However, there is a need for a change in the current Social Security system. Privatization may not fulfill its promises, but it offers an opportunity to fix a system that is inequitable between generations and is filled with economic distortions. The transition to a privatized Social Security may not be as “painless” as its proponents claim, but it is a necessary step to take to remove today’s dysfunctional Social Security system.

References:


The controversy over capital punishment has been debated for many years, and continues to be a hot button political issue around the world today. Most arguments over it revolve around morality and justice. Many industrialized nations today, the United States being the most notable exception, have banned the death penalty because they describe the punishment as barbaric, cruel, or inhumane. Even in the U.S. only a handful of states use capital punishment. Although it is customary to use terms like justice, vengeance, and morality, the economic debate over capital punishment hinges on deterrence.

Much of the early so-called economic work on crime was simple, crude, and contained flawed generalizations. In 1968, Gary S. Becker applied basic microeconomic principles, specifically the Subjective Expected Utility model to crime, marking the beginning of comprehensive economic study in the field of crime (Cameron, 2002). His studies stated that imprisonment for crimes not only punish, but also prevent crime through the threat of punishment. Isaac Ehrlich’s “The Deterrent Effect of Capital Punishment: A Question of Life and Death” introduced the idea of a possible deterrent effect of capital punishment. The U.S. Supreme Court referred to this article when it decided to re-institute capital punishment in 1976 (Cameron, 1993). Although the conclusions of his 1975 article have been criticized often, Ehrlich’s model has yet to be conclusively disproved. Most other economists that work in the field of crime, including Dale Cloninger and Stephen Layson, have come to similar conclusions using totally separate and slight variations of Ehrlich’s methodologies in approaching a possible deterrent effect of law enforcement and capital punishment (Cameron, 2002).

The deterrent effect of capital punishment is its ability to prevent would-be murders by executing some criminals convicted of capital crimes. Most economists that believe in this tradeoff agree that capital punishment is justified only because of its ability to deter. Capital punishment cases usually have higher costs with increased lawyer fees and a longer appeals process. The rest of society often pays for these fees. There is also an incredibly high amount of disutility to society and an individual if an innocent person is mistakenly executed. None of this would be economically reasonable if not for deterrence.

Crime and Society

One of the basic assumptions of most economic models is that of the rational consumer. Some criminals may have deranged, illogical minds that cannot comprehend their actions or the possible punishments that may result. These irrational criminals are largely ignored in the economic approach to crime. The following economic approaches assume that most criminals are rational, self-interested human beings. Every analysis assumes that potential criminals can respond to (dis)incentives to commit crime, and so, crime can in some ways be deterred. A criminal’s choice to commit crime is simple utility-maximization.

A person can choose between doing legal activities and committing crimes. This choice is influenced by the benefits and costs of performing the crime. The benefits are clear-cut; it is the utility gained from the crime. The costs of the crime depend on a number of...
issues. First, the probabilities of being arrested, convicted, punished, and executed must be taken into account. The opportunity cost of the crime, especially the substitute of legal activities also is considered. Hence, people with high opportunity costs to crime, such as a high-paying job, would be less likely to commit a crime than those with smaller opportunity costs to crime. Then, if we assume people have similar tastes, everyone technically is a potential criminal. Those that perform crimes have different benefits and costs (Cameron, 1994).

Crime can be simply defined as any act that violates the law, which is punishable by the state. A crime almost always provides a disutility to society as a whole. In turn, society responds to this externality by paying for law enforcement, courts, and a prison system. The society is trying to minimize its costs by reducing crimes through this system, and arguably gaining some sort of utility with the acknowledgement that criminals are being punished.

We can assume that the death penalty is a worse punishment than life imprisonment for any rational prisoner. The main evidence proving this is that individuals sentenced to death have almost always tried to get the sentence commuted to life imprisonment. However, there have been practically no instances of someone receiving life imprisonment and then attempting to get the sentence changed to death (Ehrlich, 1975). This leads to the conclusion that the death penalty is the worst punishment possible in the United States.

**Ehrlich and Capital Punishment**

Isaac Ehrlich wrote the most revolutionary and influential work on the deterrent effect of capital punishment. Becker’s supply of crime model showed that increasing police force, higher conviction rates, and harsher prison sentences could deter crime. By increasing the likeliness of getting arrested and issuing longer sentences, the cost of committing the crime in the first place is higher. Hence, some crimes would be prevented. Ehrlich applies this concept to capital punishment.

As stated previously, crime can be seen as a utility maximizing function. If the expected utility of performing a crime were greater than the expected utility of legitimate activities, a person would logically commit the crime. Similarly, if the expected utility of legitimate activities is higher than the expected utility of committing a crime, the potential criminal is just another law-abiding citizen. Ehrlich’s utility function of committing a capital crime can be summarized as follows (Cameron, 2002):

\[ EU = (1 - PCON) U (C_0) + PCON (1 - PE) U (C_1) + PCON x PE U (C_2) \]

**EU:** Expected Utility

**PCON:** Probability of a murder conviction

**PE:** Conditional probability of an execution

**U (C_0):** utility if not convicted

**U (C_1):** utility if convicted, but not executed

**U (C_2):** utility if executed

The first part of the equation yields the prospective criminal positive utility. It measures the utility of the murder multiplied by the probability of not being convicted. The second part of the equation brings disutility. The utility multiplies the probability of a conviction, the likeliness of no execution, and the negative utility of the prison term. The final part multiplies the probability of conviction, the conditional probability of an execution, and the enormous disutility of being executed. The enormous disutility of an execution to the prisoner brings the overall expected utility lower than if there was no possibility of execution (PE=0). A decrease in the expected utility makes murder less likely. Hence, anything that causes such a decrease, including the existence of capital punishment, can be a deterrent to murder. This is the basis for the Ehrlich’s murder supply theory and ultimately leads to his conclusion that capital punishment deters potential murders from ever happening.

The above model shows that increasing the probability of apprehension by a certain percentage decreases the expected utility of murder by an even greater percentage (Ehrlich, 1975). By increasing the probability of being arrested, there is also an increase in the probability of being convicted (and imprisoned). An increase in the probability of a conviction then increases the probability of an execution. An increase in the probability of executions, however, increases neither the probabilities of arrests nor convictions. Because of the rebounding effects, we can conclude that an increase in the probability of arrests has a greater deterrent effect than an increase in the probability of conviction, which has a greater deterrent effect than an increase in the probability of executions (Ehrlich, 1975).

To combat the disutility that crime, especially murder, causes to society, the public pays the government to provide a system to catch and punish criminals. All else being equal, the resources put into this system are positively correlated with the probability of apprehension. However, there can also be too much enforcement. The marginal revenues from law enforcement and punishment must equal the marginal costs to society. The reasoning behind this is that law enforcement, lawyer fees, imprisonment, and executions all cost money. It is inefficient to increase spending when the costs of an additional unit of utility (protection and justice) are greater than the costs of crime being deterred.

Ehrlich recognizes that the marginal revenue from execution must be equalized with the marginal cost of crime. Similar to an equilibrium amount of law enforcement, there also exists an equilibrium number of executions. He defines the marginal revenue of execution as the value of the potential lives saved and the lower costs of law enforcement (because of the fewer murders being
committed from the deterrent effect). The marginal cost of execution is the additional costs required for the execution as opposed to life imprisonment and the cost to society of executing a person given the probability of legal error (Ehrlich, 1975). Even when factoring in the possibility of an execution of an innocent person, the overall utility (and marginal utility) of society is still higher with capital punishment because of the ability to deter. He concludes that there is an optimal number of executions, at which the marginal revenue and marginal cost equations are equal. So, there will be instances when the death penalty could legally be carried out, but it would be inefficient to do so.

...when there are executions in a society, the overall utility of society is higher than if there were none.

**Portfolio Approach**

Dale E. Cloninger is another major economic writer on the issue of the deterrence effect of capital punishment. In his article, “Capital Punishment and Deterrence: A Portfolio Approach,” Cloninger uses a different methodology with new data and conclusions that support the existence of a deterrent effect. It compares “models of changes in homicide rates in executing and in nonexecuting states relative to changes in crime rates generally” (Cloninger, 1992). Cloninger uses most of the same assumptions and conclusions of Becker and Ehrlich. Each potential criminal is rational, having a choice between legitimate activities (the risk-less asset) and crime (the risky asset). The potential criminal’s choice depends on his risk aversion and the expected utility of crime (Cloninger, 1992).

Cloninger puts all crimes into a portfolio, which together brings disutility to the victims and society as a whole. Individual crime rates are the crime rates of specific crimes, such as homicide or robbery. These individual crime rates can “vary more than, the same as, or less than the rate of portfolio crime” (Cloninger, 1992). The changes of a specific crime rate relative to changes in the portfolio crime rate are called “crime betas” (Cloninger, 1992). Crimes with betas greater than 1 vary more than the portfolio crime rate, and imply a greater risk to society of that particular crime. Similarly, crimes with betas equal to 1 vary proportionally to the overall, portfolio crime rate. Crimes with betas lower than 1 vary less than the portfolio crime rate, and imply a relatively smaller risk to society of that crime when the portfolio crime rate goes up.

The existence of a deterrent effect of capital punishment requires a smaller beta for homicide when executions do occur than the beta when executions do not occur (Cloninger, 1992). In other words, when executions take place, increases in the homicide rate relative to the overall crime rate are lower than the increases when there are no executions. Cloninger found that the homicide beta was 1.28 with the presence of executions. This means a 10% increase in the crime rate corresponds with a 13% increase in the homicide rate (Cloninger, 1992). The homicide beta in the absence of execution was 1.56, meaning a 10% increase in the crime rate would correspond with an increase in the homicide rate much larger than 13% (Cloninger, 1992). Ultimately, these results simply mean that in the presence of capital punishment there would be fewer homicides than if there was no capital punishment. Clearly, it complies with the deterrence theory.

Capital punishment could only deter murder because there is no threat of execution on other street crimes. Having shown that the homicide beta is less in the presence of execution than in its absence, the data shows that no other individual crime beta changes in such a way. Hence, if the overall crime rate is unchanged and the death penalty is put into effect (at least 1 execution), the homicide rate will fall. Cloninger concludes that the possibility of capital punishment (performing at least 1 execution) on average lowers the homicide rate by 8.7%. An increase in the overall crime rate of 6.6% would be needed to offset the potential murders deterred (Cloninger, 1992). Cloninger’s portfolio approach reaffirms the deterrent effect of capital punishment that Ehrlich first showed.
Conclusion

Ehrlich himself recognizes a problem in his theory because of marginal deterrence. In the U.S., the use of torture is outlawed. This limits the number of crimes that can be punishable by death because severe punishments cannot always easily be handed out for more severe crimes. If the death penalty can be utilized in cases of a single murder, it cannot deter that criminal from committing more murders in an attempt to avoid arrest. Therefore, the suspect has an added incentive to kill off anyone that gets in his way, including witnesses and police officers (Ehrlich, 1975). This seemingly is a flaw in a legal system that has the death penalty for only a single murder. However, a person who commits multiple murders is still more likely to receive a worse punishment (i.e., death penalty) than a person who murders only a single person. Also, if there were no death penalty, prisoners serving a life term would have no deterrence to killing other prisoners or guards (Posner, 2003).

The final issue emphasized by many people who oppose capital punishment is the possibility of an innocent man being executed for a crime that he did not commit. This is the strongest argument, and often acts as a trump card against capital punishment. Indeed, the disutility to that innocent individual and his family and friends would be extremely high. And, of course, the disutility of that individual would be indisputably taken into account (unlike a true murderer). He never lost his rights as a member of society because he never actually broke the laws and limits set by society. Some proponents claim that cases involving the possibility of an execution require so much more evidence and confidence that the person is guilty. A better argument against this is that the existence of capital punishment deters many murders. Since many more innocent people die in the absence of capital punishment, the utility loss of many innocent people being murdered is still greater than the loss of few innocent people that are executed.

Capital punishment is a fairly effective deterrent to murder. No economist has been able to sufficiently disprove Ehrlich’s conclusions, and writers, like Cloninger have only reaffirmed the existence of a deterrent effect. Because of this deterrent effect, when there are executions in a society, the overall utility of society is higher than if there were none. On these economic grounds, capital punishment is an appropriate form of punishment.

References:


Consider the following scenario. I am walking down the street when I observe a flowerpot falling off a windowsill. I can do one of two things—shout to alert the person standing under the falling pot, or look the other way. If I choose the first option, I would be offering my time and services to another without seeking any payment or restitution. The cost to me would be minimal, while the benefit to the rescued is large, if not life-saving. Interestingly, in spite of the blatant low costs and potentially high gains, only a handful of the 52 United States of America impose a duty to rescue.

In order to encourage an increase in the amount of altruistic acts, legal scholars have suggested legally binding bystanders to strangers in accident situations. In other words, in a situation with possibility for rescue, a bystander who chooses not to rescue the victim is liable to criminal prosecution and civil action from the victim. However, as the scholarship of economics in law continues to gain popularity, there has been an increasing amount of literature analyzing the economic problems and connotations that the duty to rescue and a possible Good Samaritan Law might bring about. These analyses quantify the costs and benefits of such a law on society and weigh them against each other.

In this article I try to present the economics of both sides of the argument and examine the validity of their respective claims. I will first present the case for a Good Samaritan Law, followed by the case against a Good Samaritan Law. I will then take stock of both arguments and weigh their strengths against each other and see if an alternative solution or possible consensus of improvement can be reached that would satisfy complaints from both sides of the argument. What kinds of problems might or might not be solved by such a law, and more importantly, what kinds of new problems could foreseeably arise? Will the passing of a Good Samaritan Law ultimately create more positive than negative effects on society? These are some of the questions I seek to answer in this article.

The Case for the Good Samaritan

The flowerpot example

Advocates of the Good Samaritan Law often argue that often the act of rescue may only involve calling the appropriate authorities or shouting a verbal warning. And “if one considers the low costs of prevention to B of rescuing A, and the serious, if not deadly, harm that A will suffer if B chooses not to rescue him, there is no reason…the general rules of negligence should not require under pain of liability, the defendant to come to the aid of the plaintiff.” (Hasen, 1995)

We can illustrate this hypothesis in the earlier flowerpot example with 2 characters, Mr. Bad-luck and Mr. Stranger, and a flowerpot falling from a window. If Mr. Stranger does nothing, the falling flower pot will hit Mr. Bad-luck and cause substantial head injury. We can
represent the expected utility function of Mr. Bad-luck and Mr. Stranger with the following equations:

\[ EU_{BL} = U - C_i \]
\[ EU_S = U \]

Whereby, \( EU_{BL} \) is the expected utility of Mr. Bad-luck, \( EU_S \) is the expected utility of Mr. Stranger, \( U \) is the original utility and \( C_i \) is the cost of the head injury to Mr. Bad-luck. If however, Mr. Stranger shouts a verbal warning, Mr. Bad-luck will move from the spot he is standing and incur no injury, thus transforming their expected utilities to:

\[ EU_{BL} = U \]
\[ EU_S = U - C_A \]

In such a case, \( C_A \), the cost of the altruistic action to Mr. Stranger, is trivial and represents a value so small we can assume it ultimately goes to zero. It becomes immediately obvious that in the second case, the combined utility of the two individuals is greater than that of the first case (\( 2U > 2U - C_i \)).

Market failure

Part of the problem arises exactly because the cost of his shouting, \( C_A \), is trivial; thus he is indifferent between shouting and not shouting a warning (his expected utility regardless of shouting the warning stays at \( U \) because we assume \( C_A \) to be zero). If we treat the altruistic act as a good, \( C_A \), then the market will decide on an equilibrium price; Mr. Stranger will shout the warning and Mr. Bad-luck will avoid the head injury. We should note however, that any offer from Mr. Stranger to ‘sell’ the warning at a price, \( C_i \), as long as it is lower than \( C_i \) will be accepted by Mr. Bad-luck. Even if \( C_i \) is extremely small, for example $1, this still holds true. Thus Mr. Stranger would extract a price almost as large as \( C_i \) from Mr. Bad-luck, and although the accident is averted, as a society we are being virtually no more efficient than we were earlier. Furthermore, problems of ‘setup accidents’ and ‘false saves’ might also arise.

Liability as a behavioral incentive

If we cannot trust the market to help us allocate resources efficiently in such a case, then perhaps a Good Samaritan Law is necessary. But how would a law provide such desired behavioral incentives? Legal scholars have suggests that the law “does so by treating all the regimes as pricing mechanisms, adding to the cost of an activity and thereby reducing the demand for it.” (Ogus, 2004)

Going back to the example of the falling flowerpot and for Mr. Bad-luck, who we might now call Mr. Good-luck, to be the player who is faced with choosing between shouting and not shouting a warning.

If this is true, then we can use the following model (Hasen 1995) to show that a Good Samaritan law is economically efficient. Under the Good Samaritan Law, Mr. Stranger’s expected utility is given as:

\[ EU_S = U - P(1 - p)C_A \]

If there is no such law, his expected utility is given as:

\[ EU_S = U - P(p)VLS \]

Whereby \( P \) represents the probability that Mr. Stranger is involved in a rescue situation, \( p \) represents the probability that Mr. Stranger expects to be the victim in such a situation, and \( VLS \) represents the value of Mr. Stranger’s life. If we compare the two equations, Mr. Stranger will prefer a Good Samaritan Law if:

\[ U - P(1 - p)C_A > U - P(p)VLS \]

Or by reducing the equation, if:

\[ (p)VLS > (1 - p)C_A \]

Assuming that Mr. Stranger believes the possibility of him being a victim or a rescuer to be equally likely, then he will prefer the rule if:

\[ 0.5VLS > 0.5C_A \]

If we take the rational assumption that \( VLS \) is far greater than \( C_A \), then it follows that Mr. Stranger or any other individual would surely be in favor of a Good Samaritan Law.

Self interest

In the flowerpot example, clearly Mr. Stranger would prefer not to have a Good Samaritan law; legal prosecution and civil action effectively forces his hand to choose rescue. However, it is important to remember that it is only in this instance that Mr. Stranger is the rescuer. It would be rational to think that it is equally likely for Mr. Stranger to be standing under the falling flowerpot and for Mr. Bad-luck, who we might now call Mr. Good-luck, to be the player who is faced with choosing between shouting and not shouting a warning.

The Case against the Good Samaritan

The beach example

The Beach example is a common
scenario used in argument against the legislation of a Good Samaritan Law. In the beach example, Mr. Stranger is holidaying on the beach and Mr. Bad-luck has a muscle cramp while out swimming. Mr. Stranger is now faced with a number of options; he can do nothing, he can call the lifeguard, or he can attempt to rescue Mr. Bad-luck by himself. Under the Good Samaritan Law, he must choose either of the latter two choices or face legal consequences. In this section of the paper I will outline some problems that might arise from a Good Samaritan Law

Negative activity-level effect

If Mr. Stranger knows that by going to the Beach, he is subjecting himself to the possibility of being forced to participate in a save, we might expect that he now has a “dissuasive…to be in a place where one might be liable for failing to rescue a person.” (Posner, 2003) We might explain his expected utility from visiting a ‘hazardous’ place as:

\[ EU_{S-H} = U - p_H C_A \]

In the same way we could describe his expected utility from visiting a ‘safe’ place as:

\[ EU_{S-S} = U - p_S C_A \]

Thus, if \( EU_{S-S} > EU_{S-H} \) he will avoid ‘hazardous’ places, and instead frequent ‘safe’ places where there is a lesser likelihood of him being involved in a rescue situation.

It might seem that only non-altruistic individuals such as Mr. Stranger are affected, but we should also expect the negative activity-level effect to affect potential rescuers such as Mr. Goodguy. The first reason is that even altruists, such as Mr. Goodguy, like to be given a choice before attempting the save. The second reason is that a legal duty to rescue would take away much of the positive utility, primarily public recognition, that Mr. Goodguy would otherwise have gained. The rescue is no longer an altruistic act but rather a duty that if disregarded would have resulted in legal consequences.

Anti-cooperative effect

So far we have only discussed examples of rescue from external elements such as falling objects and natural misfortune. But what of instances in which Mr. Stranger witnesses a crime being committed? For the purposes of this paper, I will take the Good Samaritan Law to include not only the duty to rescue, but more specifically at a crime scene, a duty to report.

Volokh warns that Good Samaritan laws create an anti-cooperative effect. He claims that there are 5 varieties of Samaritans – the Good Samaritan, who will help regardless of the law; the “Hopelessly Bad Samaritan”, who will not help regardless of the law; the “Legally Swayable Samaritan”, who will help if there is a law, the “Delayed Samaritan”, who does nothing initially but sometime after the incident decides to come forward and report what he saw; and the “Passive Samaritan”, who does nothing but if asked by the police will cooperate fully. We are familiar with the first two types which, for our purposes, are irrelevant because they are indifferent to a Good Samaritan Law. The Legally Swayable Samaritan is also someone we are familiar with; he is the champion of those advocating for a Good Samaritan Law and if not for the law’s incentives (legal consequences otherwise) would not have performed the rescue. In our analysis it is the Delayed Samaritan and the Passive Samaritan who are most strongly affected by the anti-cooperative effect and thus are whom we are most interested in.

If there is no duty to rescue, the Delayed Samaritan and the Passive Samaritan will cooperate fully with law enforcement authorities and the Delayed Samaritan will even take the initiative to provide testimony. If however there is a legal duty to rescue, we would be led to believe that the Delayed Samaritan and the Passive Samaritan would now be much more reluctant to help the authorities in investigating the crime. By cooperating with the police, they are in effect putting themselves at risk of being convicted of neglecting their duty to rescue or report; Volokh calls this phenomenon the anti-cooperative effect. This effect is likely to be even greater on those with questionable criminal backgrounds such as prostitutes or drug abusers because they risk greater penalties. We can take stock of the anti-cooperative effect on expected rescues in the following equation:

\[ ER = R_G + R_L - R_{LT} - R_p \]

Whereby \( R_G, R_L, R_{LT}, R_p \) are represented by the number of rescues performed by the Good Samaritan, the Legally Swayable Samaritan, the Delayed Samaritan, and the Passive Samaritan respectively. Thus if \( R_L \) exceeds the summation of \( R_{LT} \) and \( R_p \) we would be in favor of a Good Samaritan Law. However, it is unlikely that that would be the case; when a bystander witnesses a crime and does not report it, it is usually because of some irrational fear or perhaps of allegiance to the committer of the crime. Thus it is unlikely that knowledge of a duty to rescue will sway them, and we can assume \( R_L \), the number of Legally Swayable Samaritans, to be relatively small. On the other hand, we can imagine the number of Delayed Samaritans to be substantial; during the time of the crime he may have been seized by an irrational fear and thus not reported or helped, however, as time passed, this fear dissipated and he is willing to report the crime and provide assistance to the police. It would appear that a Good Samaritan Law, whose purpose was to increase the expected number of rescues, \( ER \), may in effect lower the number of rescues because we would expect the summation of \( R_{LT} \) and \( R_p \) to exceed \( R_L \).

High enforcement costs, loss of liberty costs, and level of care

Another primary argument against a Good Samaritan Law is the difficulties and high costs associated with the enforcement of such a law. How would law enforcement agencies prove that Mr. Stranger or any other individual who allegedly neglects his duty to rescue truly witnessed the accident? And if this is proved, how then would they prove that
his failure to rescue was not simply the result of a misjudgment or an overestimation of the level of danger involved in the rescue? Furthermore, any witness who is willing to identify Mr. Stranger as having witnessed the crime is effectively admitting his own failure to rescue or report, and thus would be equally reluctant to come forward. A possible solution could be to increase the number of law enforcers, but the financial costs of doing so would most likely outweigh the benefits of the few additional rescues.

The Good Samaritan Law essentially limits the choices an individual can make when faced with a rescue situation. Mr. Stranger technically has a choice of not rescuing an individual, just as a person being mugged has the choice to not hand over his wallet, but for the former his doing so would result in legal consequences and for the latter possible loss of life. This loss of civil liberty to each individual may not be a large value, but the summation of this cost to each individual in society, particularly one with a large population, would no doubt be substantial, and would most likely outweigh the social benefits that such a law would provide.

Furthermore, there is a danger that a duty to rescue will see more individuals who are not in a position to rescue, participate in an accident situation as a rescuer. For example, a weak swimmer attempting to rescue a drowning victim would do more harm than good. Also, there is a concern that if the duty to rescue is a legal one, the rescuer is less likely to be careful because he is essentially being coerced by the law to engage in the rescue. An unwilling rescuer might again cause more harm to the victim than good and aggravate any injuries that the victim already has by being rough.

The arguments both for and against a Good Samaritan Law establish valid economic points. We have seen through models proposed by both sides that indeed their arguments contribute to a greater efficiency in the allocation of resources. But how can this be? Either the law increases efficiency or it doesn’t; the two are mutually exclusive and both cannot allocate resources more efficiently than the other. Thus we compute a cost and benefit analysis of the law, but in doing so we must first examine the arguments’ underlying assumptions in order to balance the validity of their claims.

A small value $P$ and the large cumulative value of $C_L$

The economic reasoning behind the model for the efficiency in duty to rescue, $\{U - P(1 - p)C_L > U - P(p)VL_s\}$, is compelling. It would be fair to say that “individuals assess the probability of being a victim or potential rescuer as equal” and even for individuals who see their probability as being biased towards always being a rescuer (a large value $p$), it is likely that the reasoning holds true simply because the value we place on our own lives is far greater than the cost of our altruistic actions. However, his model hinges on the probability, $P$, that the individual believes he will be involved in a rescue situation. If the value of $P$ is extremely small, the expected utilities with and without a Good Samaritan Law become closer and closer, and indeed if the value of $P$ is zero, then we are once again indifferent between having a Good Samaritan Law. It is highly likely for us to place a small value to probability $P$; few rational people go through their days believing that they will witness a crime, warn a person of a falling flower pot, or rescue a drowning swimmer – even if they are at a beach or pool. On the other hand, the loss of civil liberties is a cost, $C_L$, independent of probabilities. This loss under the law is illustrated by:

$$EU = U - P(1 - p)C_L - C_L$$

As mentioned earlier, the individual cost of $C_L$ may not be great, but if we take the summation cost it has on society, we see that it will significantly decrease the overall utility in society.

High enforcement costs and difficulties of behavioral incentives

In order for the law to act as a behavioral incentive, individuals must believe that they are likely to be prosecuted. For example, it would be fair to assume that more students are willing to cheat on their homework than they are on their exams or tests; the likelihood of a student ‘rephrasing’ his classmate’s homework being caught is much lower than the likelihood of a student being caught cheating in an exam, and thus the former happens more often. As outlined earlier, enforcement is not only extremely costly but also exceedingly difficult. It follows that any individual who neglects his duty to rescue believes his likelihood of being caught to be relatively small. Thus the argument that a Good Samaritan Law serves as a significant behavioral incentive is unlikely to be valid.

The negative-activity level effect

In order for the negative-activity level effect to influence an individual, we must assume that he is able to determine the difference between a ‘hazardous’ and a ‘safe’ place. I believe, and advocates of the Good Samaritan Law argue, that the assumption that an individual can easily distinguish between a ‘hazardous’ and a ‘safe’ place is an erroneous one. Part of this is tied to the low probability, $P$, that an individual believes himself to be involved in a rescue situation; if $P$ is low, then the distinction between a ‘hazardous’ and a ‘safe’ place is no longer clear.

Moreover, the negative-activity effect assumes that the utility we receive from going to a ‘hazardous’ place is equal to the utility we receive from going to a ‘safe’ place. Is the utility generated from seeing a movie or going to the library, both ‘safe’ activity, equal to that generated from ‘hazardous’ activities such as camping and going to the beach? It is difficult to compare the two and thus I find the negative-activity argument
unconvincing.

The anti-cooperative effect and the duty to cooperate

A far more convincing and serious objection to a Good Samaritan Law is the anti-cooperative effect. If by helping law enforcers with their testimony an individual is admitting he failed his duty to rescue, it is unlikely that the Delayed Samaritan or the Passive Samaritan will cooperate with authorities. We might suggest that prosecutors have the power to drop charges for specific witnesses who are willing cooperate, but doing so would render the witness less credible in front of a jury; he is providing testimony in exchange for his freedom. We might then suggest a change in the law that allows individuals such as the Delayed Samaritan and the Passive Samaritan immunity once they cooperate. But in doing so we would be changing the law from a duty to rescue to a ‘duty to cooperate’, and we lose exactly the benefits that society hopes to gain from a duty to rescue. Furthermore, such a law would be redundant as there are existing legal tools, subpoenas for example, that force witnesses to cooperate.

Conclusion: Going beyond the Good Samaritan Law

A cost benefit analysis from an economic standpoint shows that, because of the difficulties and the high costs involved in enforcement, the overwhelming anti-cooperative effect, and the cost of the loss of legal liberties on society, a Good Samaritan Law would ultimately decrease efficiency in the allocation of resources in society.

If the Good Samaritan Law cannot help us efficiently allocate resources in society, is there another solution that can help us achieve the desired behavioral incentive to act altruistically? I believe that the majority of individuals do not need to be coerced into behaving altruistically; there are social norms that guide the way in which we make choices and informal costs that we have to take into consideration. If an individual sees a drowning person at a beach, I postulate that his first instinct is to call for a life guard. If we are optimistic we might say that he is acting altruistically. If we are cynical we might say that he is acting out of personal benefit; the cost of a guilty conscience and possible stigma from the public may be too high. But regardless, I am led to believe that a duty to rescue is so intrinsic in the moral fabric of the most of us that choosing rescue is an act out of our subconscious, and thus attaching a legal duty does little good in helping us make this decision.

However, altruistic acts are beneficial to society, and accordingly, altruists should be rewarded or at least encouraged. I am not suggesting victims legally owe their rescuers restitution, but rather that the government should step in. Gold stars and war stripes are hardly a fair compensation for the risks war heroes take in fighting for their country, but either through education or propaganda, governments have swayed their citizens into risking their lives, often repeatedly, for their country. Legal incentives may not be the best solution for allocating resources efficiently, but where the Good Samaritan Law fails the governments must pick up.

References


NO! to Internet Taxes

By: Jarett Goldman

If you can show me an untaxed corner of the economy, I will show you a politician eager to tap a new source of revenue. So it is with the Internet, which has America's 30,000 state and local taxing jurisdictions jumping at the thought of gaining extra revenue from this promising new industry.

Absent from their thinking is the fact that subjecting digital commerce to 30,000 different sets of tax collectors would hamper one of the fastest-growing segments of the U.S. economy. Supply-siders have long argued that economic incentives, especially after-tax returns, influence individual and business behavior. When you tax something, you get less out of it and when you tax something less, you get more out of it. This is why sales taxes matter as much as other taxes. When former New York Mayor Rudolph Giuliani declared a sales-tax holiday, sales volume soared. By contrast, it was the threat of a new tax that helped lead to the October 1987 stock market crash.

This logic suggests the harm that a sales tax would inflict on Internet commerce. Imposing an Internet sales tax would create an unnecessary tax burden that both raises producer costs and leads to a decrease in consumer volume.

For the time being, however, e-commerce is booming. It is attracting new customers who will increase overall retail sales. Quick and convenient Internet shopping is very appealing to the growing elderly population, as well as busy executives, stay-at-home moms, bargain hunters, the sick, the handicapped and others.

More impressive yet is electronic commerce's growth potential. Think of the mass-production of telephones and automobiles in the 1920s, or the jump in purchases of washing machines and television sets following World War II. In both periods, new technologies spurred long-term prosperity and stock market surges. It is only fitting to put the Internet and e-commerce in that category (Bettelheim, 1999).

But for those who are intent on instituting some type of Internet tax, there is another barrier: the U.S. Constitution. The Founding Fathers (wisely may I say) included a section in the Constitution that prevents states and localities from taxing interstate commerce, which is exactly what electronically transmitted information is. When any good enters the realm of interstate commerce, the “Commerce Clause” gives Congress the sole power...
to regulate its transactions.

While the founders could not have envisioned the development of the Internet, the Constitutional framework they outlined for basic commercial activities still applies. State and local officials may not like it, but their taxing authority ends at their borders.

Moreover, even if states and localities had the proper authority to tax the Internet, they would run into a number of problems. Electronically transferred information travels across the Internet far too quickly for regulators to monitor and, more importantly, does so in a way that respects no geographic boundaries (Bettelheim, 1999). It is virtually impossible to know the points at which the billions of daily Internet transactions begin and end. Consequently, state and local attempts to tax such intangible electronic commerce would result in a confusing and overlapping set of tax laws.

The growth of satellite-based technologies and the wireless transmission of information will only add to the confusion. As an increasing amount of Internet traffic is transmitted wirelessly across the United States and around the world, the jurisdictional claims of states and localities will certainly be blurry at best. States and localities will have to be content with taxing firms that provide Internet services within their jurisdictions. Anything more than that will become legally and logistically impossible (Bettelheim, 1999).

The boom in electronic commerce demonstrates once again the enormous benefits of the Internet. But, it must be realized that tax freedom leads to cheaper products, easier access, stronger growth and happier consumers. Politicians in Washington should think twice before contemplating the imposition of tax or regulatory obstacles that would cripple the technological revolution that has become the spine of our dynamic new economy.

References:

Politicians in Washington should think twice before contemplating the imposition of tax or regulatory obstacles that would cripple the technological revolution that has become the spine of our dynamic new economy.
Exchange Rate and Current Account Imbalances in China and ASEAN: Are They A Problem?

By: Ray Wang

The undervaluation of China’s currency and current account imbalances in a number of ASEAN (Association of Southeast Asian Nations) countries have widened since the early 1990s. ASEAN was established on August 8, 1967 in Bangkok by the five original member countries: Indonesia, Malaysia, Philippines, Singapore, and Thailand. The currency and trade imbalances in this region have generated concern that policy measures may be required in order to avoid costly and destabilizing shifts in the world market, such as those witnessed during the East Asian Crisis. During this 1997-1998 crisis, export revenues of many East Asian countries did not increase despite massive currency depreciation by the afflicted economies. Concern over current account imbalance has been expressed with respect to China and five major ASEAN countries. Both Malaysia and Thailand’s current account deficits widened to over eight percent of GNP by the mid-1990s. Concerns have been raised about the widening deficit of these country’s external debt and service debt levels, which are significantly higher than anywhere else in the world. Several years of rapid growth caused by the imbalance have absorbed the initial slack that existed in these countries, but now, overheating may instead become a problem. If left unchecked, large external deficits combined with overheating of an unsustainable economy will expose these Asian countries to external shocks and political unrest.

Countries should be concerned about large current account deficits and surpluses because they are simply unsustainable in the long-run. There are instances when a deficit may be warranted, for example borrowing today to improve productivity in order to have a higher national income tomorrow. But, for any period of current account deficit, there must be a corresponding period in which spending falls short of income (i.e., current account surplus) in order to pay the debts incurred to foreigners. In the absence of extraordinary investment opportunities, the best course for a stable economy is to follow a path of consumption smoothing. A current account surplus means that a country is a lender on the world scene and may experience an imbalance of payments. The official settlements balance (balance of payments) is crucial to every country. The reserves of foreign currency held by a country’s central bank change its official settlements of balance. Thus, central banks can readily use their foreign currency reserves to influence exchange rates. A depletion of foreign reserves, due to lending or trade imbalance, will then limit the central bank’s ability to influence or peg these rates. It is extremely important for any country to have control over its exchange rate in order to prevent speculators and other external factors from depreciating or...
inflating its currency value. For some countries, particularly developing Asian nations, central bank reserves are important as a way of allowing the economy to maintain consumption or investment when foreign borrowing is difficult. A high level of reserves will also perform a signaling role by convincing potential foreign lenders that the country is credit-worthy. Thus, it is optimal to have a balanced current account and not fall into the trap of being a huge borrower or lender in the international arena.

The current account represents the rate at which a country accumulates or decumulates foreign assets. One approach in determining whether an external imbalance is a problem is to analyze the assumption that all external debts will ultimately be paid. This is the notion of “intertemporal solvency.” However, intertemporal solvency is a relatively weak indication of emerging problems because solvency requires that all debts are repaid, but only in the very long run. This parallels current United States taxation and Social Security policies, where massive debts are accumulated and justified through long-term policy adjustments that will not occur until the distant future. This allows a country to remain technically solvent, even while running large external deficits, as long as policies are adjusted in the distant future to bring about the required surpluses. The alternate, and more effective, indicator of whether current account deficits are a problem is based on a model of optimal borrowing and lending posited by economist Paul R. Krugman (2003). The model incorporates intertemporal solvency with private expectations about future income growth, investment, and fiscal policy.

The industrialization of China and undervaluation of the renminbi is the premier example of current account and exchange rate imbalance. Recent evidence would seem to indicate that the Chinese economy is overheating. Bank loans are expanding at a frenetic rate, and the pace of investment recalls what happened in other Asian countries in the days before the East Asian Crisis. The statistics tell us that China has been in current account surplus for a long time.

Recent evidence would seem to indicate that the Chinese economy is overheating.

These include the underlying decisions of how much to save or consume in a given period. By utilizing these expectations, the model is able to provide an optimal consumption-smoothing current account. This optimal current account balance can serve as a benchmark to judge the evolution of the current account. If the deficit of a nation exceeds the optimal deficit generated by this model, this provides an indication of “over-borrowing.” Such indications of excessive borrowing are especially prevalent in Thailand and most other ASEAN countries.

Not only that, but China has been a net capital importer. It is a country that is still underdeveloped but has the fundamentals in place to permit rapid growth if it invests heavily. Because of these two factors, Chinese reserves have grown to a point where they are now the second highest in the world (after Japan). The growth of China’s economy, both from internal and external factors, points to the desirability and necessity for a currency revaluation. This would relieve tensions in the domestic economy, as well as diminish the external surplus and reserve accumulation.

How large a revaluation would be desirable? That depends on how large an adjustment is deemed to be appropriate. In 1996, Molly Mahar postulated a current account deficit of 2.8 percent of GDP as a reasonable objective for China over the following years, on the grounds that China is a developing country that can expect investments in excess of savings generated at home. China would have no difficulty in importing enough capital to finance such a deficit. In fact, China has imported capital, but on a somewhat smaller scale than this, at an average rate of one percent of GDP per year.

World leaders have been critical of Chinese resistance to a revaluation of the renminbi, but Chinese authorities were absolutely right to resist US Treasury Secretary John Snow’s call for
a liberalization of the capital account and for a float of the currency. The danger of Snow’s proposal lies in the fact that liberalization of the capital account would cause many Chinese savers to switch a part of their portfolio to foreign countries, in order to avoid holding money in Chinese banks if and when a financial crisis finally hits. The attempt of many savers to safeguard their position in this way is likely to bring about the very calamity they were trying to avoid in the first place, as is normally true in a bank run. The obvious policy response for the Chinese government is to delay capital account liberalization until after the banks have been cleaned up. This would be in accordance with the conventional wisdom of the sequence of liberalizing a financial system, which is to liberalize the capital account at the end of the restructuring process, not at the beginning.

If capital account liberalization did in fact cause a substantial capital outflow, then it would cause a depreciation of the renminbi rather than an appreciation. While market fundamentalists may shrug their shoulders and say “so be it,” more pragmatic economists would regard such an outcome as counter productive, as it would further strengthen China’s current account imbalance. It would do little to help China overcome the financial crisis that has been thrust upon it, and it would do nothing at all to resolve world trade imbalances, especially the US payments deficit.

John Williamson was the World Bank's Chief Economist for South Asia during the East Asian Crisis: “just after the crisis had broken, there was still some pressure to implement the recommendations of the Tarapore Committee that had reported to the Indian government shortly before the crisis, and which recommended a "gradual" process of capital account liberalization lasting three years. I told an Indian newspaper that I thought thirty years would be more realistic” (as qtd. in Williamson, 2003). It seems that China should be thinking of a similar timescale to complete the liberalization process. That would then put Asian countries on the same sort of timescale that Europe followed when moving back to a liberal economy after World War II. While the process was slow, it was also thorough, which resulted in few worries that Europe may revert to a repressed economy. According to Williamson, “that is vastly better than a rush to liberalize followed by backtracking, as has often occurred in Latin America (with Argentina being a dramatic recent example)” (as qtd. in Williamson, 2003).

The currency and trade imbalances in China and the ASEAN will eventually cause economic problems in the future. However, China should continue to resist external political pressures from the United States and Europe for the immediate restructuring of its currency and liberalization of the capital account. It would be economically devastating to liberalize the capital account and float the exchange rate in an untimely manner. Rapid appreciation of the renminbi will cause China to dive into an economic crisis. Bank runs, combined with a lower current account and GDP, will overwhelm the economy. The confidence level of foreign investors and domestic citizens in the stability of a nation’s currency is the foundation of a stable economy. Any economically stable nation has to have control over the ability to peg the exchange rate. On the other hand, the ASEAN countries are not as industrialized as China, and the correct policy for the ASEAN would be to scale back borrowing from the richer countries and not overheat the economy. In order for this to work, such economic policies must be initiated and carefully followed without political interference from external factors.

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The Development of the Chinese Automobile Industry

By: Samson Cheng

Since the turn of the century, businesses around the globe are putting most of their attention on the world’s fastest growing market – China. As conditions for entry into the World Trade Organization in 2001, China has been gradually opening up its economy to foreign investors. Multinational corporations in every sector have set up ambitious plans to get a share of profits in the fastest growing market. In the automobile industry, the reduction in duties and tariffs in recent years have attracted automakers from Detroit and Stuttgart to pour in billions of dollars into building new plants and training staff in the world’s most populated country. The automobile market has seen impressive growth in recent years. The potential seems to be enormous. But is the growth sustainable? Are the international auto giants’ moves into the market too abrupt?

**Potential in the Chinese Automobile Market**

The Chinese automobile market has long made car makers around the world salivate. According to J.D. Power and Associates Inc., there are 8 vehicles per 1000 residents in China, compared to 940 in the United States and 584 in Western Europe (Roberts & Welch, 2004). With a population of 1.3 billion (four times of the U.S.), China has just surpassed Germany, where half the population owns a car (Tierney, 2003), as the world’s third largest auto market in terms of car sales, behind the U.S. and Japan. It is expected that this most sought-after market could leapfrog Japan by 2007 and even the U.S. by 2020 to become the largest auto market in the world.

With around 10% annual GDP growth in consecutive years, China has enjoyed economic prosperity over the past decade. Now the country has seen the emergence of a middle class with enormous purchasing power. As the communist state transforms its economy into a capitalist one, individual buyers have become the new driving force for the auto market. Sales of Volkswagen in China are now higher than that in its home market of Germany. China has also become BMW’s biggest market for the most expensive 7-series sedan, even though the Chinese are paying double what Americans pay (Roberts & Welch, 2004).

The growth sprint began in 2001 as China became a member of the WTO. As required, the Chinese government lowered the tariffs and allowed foreign competition in the domestic auto market. This move has made cars produced by protected local carmakers (with inferior quality and old-fashioned design) no longer saleable. With struggling performance in Europe and the U.S. as a result of a global price war, automakers around the globe could not wait to seize the opportunity as a relief. Automakers such as Volkswagen and General Motors began to build plants with their Chinese partners. At the early stage, they found

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that their production capacity could not keep up with demand and had to complement the sales with imported cars before further expansion of its manufacturing plants were completed. Not able to wait any longer for a share of the cake, automakers have announced ambitious plans to increase production in China. GM is planning to spend $3 billion to double its production capacity to 1.3 million vehicles by 2007. Volkswagen is pouring in $6.3 billion to double capacity to 1.6 million units by 2008. Ford Motor Co. wants to spend $1 billion on expansion in China, while Toyota will invest $730 million to expand capacity in its plants in Guangzhou and Tianjin. According to consultancy A.T. Kearney Inc., nine multinational carmakers are planning to spend $9.7 billion in total between 2003 and 2007, boosting the country’s annual production to 5 million passenger cars (Balfour & Wu, 2004).

All these have reflected China’s emergence as the most sought-after market. The country has attracted 60-80% of the foreign automakers’ international investment (Xinhua News Agency, 2005). Annual growth rates in sales have been impressive at 60% to 70% in recent years (Standard & Poor’s Rating Services, 2005). In 2003, General Motors made $437 million in China, almost half of its global profits (“Rick Wagoner on GM’s Chinese future,” 2004).

**Dramatic Slowdown in Growth**

Prospects have been very promising to foreign automakers. However, while plants are being constructed across the country to prepare for future waves of market boom, auto sales have indeed begun to slow down. In 2004, 2.33 million passenger cars were sold in China, representing a growth of 15% (Standard & Poor’s Rating Services, 2005) after nearly doubling in 2003.

The Chinese economy has sustained high growth for over a decade, but economists today argue that there are signs of overheating in the economy. Overly rapid growth in industries such as steel, cement, and real estate has been fueled by financial institutions’ loose lending practices. Standard & Poor’s estimates that 40% of business loans in China are nonperforming (Roberts & Welch, 2004). Fear of a bubble burst has prompted the government to slow down investment and cool down the economy. The People’s Bank of China, the Chinese central bank, has ordered the nation’s financial institutions to impose tougher requirements for giving car loans. The middle class, estimated to be 60 million, are largely put off by the state’s effort to rein in its overheated economy. At the auto dealerships in cities along the wealthier coastal regions, more customers are looking instead of buying. As a result of the credit restriction, 10% of car purchases were financed with loans in 2004, down from 35% in 2003 (Balfour & Wu, 2004).

As more automakers have jumped into the Chinese market, stiff competition has led to price wars. While auto dealers believe the price cut will help boost the car sales, there comes the unintended effect: people now are putting off their plans to buy a car, waiting for even deeper discounts. Automakers now begin to feel the effect of intensified pricing pressures and weakened profitability. According to 2004 statistics from the China Association of Automobile Manufacturers, among the nation’s 15 large-scale automakers, only nine reported sales growth over the previous year, and only five achieved profit growth (“China’s auto sector enters restructuring stage,” 2005).

Automakers that reached out to the new middle class were the ones that have suffered the most in the slowdown. Now they realize the middle class is not quite there. Indeed things are not as glamorous as they appear to be, seen in cities such as Shanghai and Beijing. Unemployment rate remains high at 10% in 2004 (Economist Intelligence Unit, 2004), leaving approximately 78 million people jobless (more than half the workforce of the U.S.). As further restructuring takes place in state-run companies, unemployment rate is expected to rise further.

With estimated annual production of 5 million vehicles by 2007 and the sudden slowdown in sales growth, concerns over a bubble burst in the auto market have recently arisen. Car sales in February 2005 were already down by 24% year-on-year. If sales do not catch up with production output, it would mean a disaster in the industry with inventory beginning to pile up. Did the foreign automakers make a mistake in extrapolating the initial trend of high growth into the 1.3 billion population? (Xinhua News Agency, 2004)

**Future Prospects**

Will China run into an auto market overheat like the Brazilian economy did in the early 1990s, when plant capacity was twice the demand? Such worry is not apparent among the executives in Detroit. Despite economists’ warnings against excess capacity, automakers believe the Chinese administration can do a better job than Brazil in handling the market overheat, based on past record of management of the economy since the 1980s. The fact that China has the world’s second largest foreign currency reserve has given foreign investors further assurance.
Currently, almost all the vehicles produced in China are intended for internal sales. If serious overcapacity does exist in the near future, there needs to be a way out for the automakers. With sluggish sales in their home countries of Europe and the U.S., foreign automakers see moving production bases to China as a possibility in the future, when workers and manufacturing method meet international standards. The automakers hope to sop up excess production by exporting Chinese-made cars.

People now have been talking about the same things that were being said about Chinese-made electrical appliances a decade ago. In the early 1990s, when Chinese firms began exporting electrical appliances, Japanese and American firms did not even consider them as competitors. Today you can walk into Best Buys and easily find a Lenovo computer or a Haier refrigerator. A decade ago people might think it was a joke. The “China price” has led to the emergence of Chinese brands as global players. No matter what the result of the stiff competition will be in the future – the ultimate winner of the auto boom will be China itself. Current Chinese regulations forbid foreign investors to own more than 50% of a Chinese car manufacturer and require that they partner with Chinese companies to enter the market. With the help from the west, Chinese automakers in the future will benefit from technological spillover. The ownership restrictions on foreign carmakers will allow local firms to develop their own brands without much reliance on the foreign partners in the future. It may not be surprising that by 2020, Chinese automakers, like Hyundai in Korea, will be exporting cars under their own brand names to the U.S., Japan, and Europe.

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The wave of foreign acquisition of Chinese banks reached a record high with London-based HSBC buying 19.9% stake in the Shanghai-based Bank of Communications for 1.75 billion, an investment eight times larger than any previous foreign investment in a Chinese bank. As one of the leading foreign banking institutions in China, along with Citigroup and Standard Chartered, HSBC’s strategy in China reflects a growing trend among foreign banks. Specifically, that of increasing banking market penetration through gaining minority stakes in small- and medium-sized commercial banks, instead of investing in the traditional Green-field joint-venture projects. Current restriction limits foreign ownership to a maximum 25% in any single banking entity. This strategy surely allows the foreign investors to extract the most profits from Chinese consumers’ rising financial needs. Yet, forces that motivate the performance of this strategy also indicate that foreign firms are betting on the uncertain prospect of fundamental banking-sector restructuring in China.

**Factor & Demand conditions**

One of the first incentives for acquisition of minority stake is expanding market demand conditions: foreign minority stake in China often expands operations in wealth-management, dual-currency credit cards, insurance, and renminbi (RMB) businesses. However, success along the dimension of demand conditions would not be realistic without complementary factor conditions, namely, a broad consumer base. Although the geographical restrictions on renminbi business by foreign banks will be removed completely by December 11, 2006, RMB business cannot be conducted without branch networks. This requirement of developing extensive network access for resource and strategic assets seeking has significant limitations in the traditional green-field joint-venture projects. If foreign banks were to set up their own distribution channels, the capital requirement for new branch is 500 million, which automatically eliminates operations in second- and third-tier cities (Dolven, Winn & Murphy, 2004), which carry greater potential for future growth and opportunity for expansion in RMB deposit businesses. Therefore, the burden of restrictions and regulations on branch establishment has prompted foreign banks to divert from the traditional Greenfield joint-venture projects, and instead, invest minority stakes in Chinese banks organized as companies limited by shares (CLSs), which are not subject to the same stringent requirements (Howson & Ross, 2003). When the foreign firms gain a broader customer base, more foreign funds, sophisticated western assistance and services are also simultaneously infused into the local banks. As China plans the gradual opening of its capital account, there would be more competition among foreign banks for RMB businesses. Gaining access to distribution channels already implanted by a local commercial bank becomes the preferred mechanism to broaden the reach to China’s vast population.

Yet the ability to impose a more advanced banking standard, which is much needed for the branches to be successful in gathering RMB business, may not be automatic if foreign banks can only impose minority influence on the board. China’s corporate law is more adverse to the protection of minority rights, whether in participation or veto power. China’s Company Law requires 2/3 approvals for resolutions at the CLSs, stripping the veto power even of holders.
Economies,” Chen and Finlay claim that achieved overall risk reduction. Establishments such as Citibank have also an innovative service in a foreign locale, levels of western services. By launching between Chinese customers with higher combination allows for synergy linkage business establishments. Such a market before developing their own strategic familiarity with the Chinese opportunity for the foreign firm to gain represents the unique investment may not issue their own local credit cards for the Chinese. Though foreign firms launch dual-currency credit card services to Shanghai Pudong Development Bank to In early 2004, Citibank partnered with Shanghai Pudong Development Bank to launch dual-currency credit card services for the Chinese. Though foreign firms may not issue their own local credit cards until 2007 at the earliest, the combination represents the unique investment opportunity for the foreign firm to gain strategic familiarity with the Chinese market before developing their own business establishments. Such a combination allows for synergy linkage between Chinese customers with higher levels of western services. By launching an innovative service in a foreign locale, establishments such as Citibank have also achieved overall risk reduction.

However, it is important to note much recent development in the region would help foreign firms to generate more success along the factor and demand conditions. In a policy statement released in February 2005, the Chinese government has claimed to allow more private-sector competition in the banking industry. The government also has the impending goal of removing restrictions on customers of foreign banks in conducting local currency business, and granting “National Treatment” to foreign banks according to its WTO commitments (Dolven et. al., 2005). The China Unionpay company has also been established to facilitate the inter-change and transaction for bank’s card businesses (Dolven et. al., 2005).

**Synergy**

In early 2004, Citibank partnered with Shanghai Pudong Development Bank to launch dual-currency credit card services for the Chinese. Though foreign firms may not issue their own local credit cards until 2007 at the earliest, the combination represents the unique investment opportunity for the foreign firm to gain strategic familiarity with the Chinese market before developing their own business establishments. Such a combination allows for synergy linkage between Chinese customers with higher levels of western services. By launching an innovative service in a foreign locale, establishments such as Citibank have also achieved overall risk reduction.

In “A Review of Cross-border Mergers and Acquisitions in APEC Economies,” Chen and Finlay claim that the synergies in cross-border M&A often come in two forms: static and dynamic. Static synergy emphasizes pooling of management resources and using each other’s market base and distribution channels to enhance revenue. It is particularly important “in industries with increased competitive pressure, falling prices and excess capacity.” At the same time, the authors pointed out that dynamic synergy exists through the matching of resources and skills to improve innovatory capabilities in industries of “increased competitive pressure, falling prices and excess capacity” and is beneficial to sectors of fast technological growth. The single most important synergy that must take place between foreign and Chinese banks is the improvement of credit ratings mechanisms aimed at reducing non-performing loans (NPLs) and infusing more transparency in banking practices. Due to an underdeveloped capital market, bank assets comprise 77% of all financial assets in China compared with 26% in America (Bowers). Local managers’ lack of training in credit assessment largely lies in the fact that they are being awarded on basis of asset growth. Although from 2007 all commercial banks must attain the international benchmark in having a capital requirement of 8% of risk-weighted assets, banks are still only subjected to a maximum loan-to-deposit ratio of 75% (Dong, 2005). Without institutionalized mechanisms to deal with a NPL issue that is as high as 50% of total outstanding loans, the core of asset businesses in the Chinese banking sector would certainly deter the synergistic growth between the local resources offered by host economy and operational expertise brought by foreign banks. The local banks are in desperate need of acquiring a profit-oriented management that can properly control credit risk.

The ease of minority stake acquisition is also not as flexible as one might imagine given the recent acquisition successes. There are regulations governing foreign investment in commercial banks and foreign purchases of equity in Chinese companies in private transactions. However, no law or regulation provides a legal basis for foreign or foreign-invested entities to purchase stocks in Chinese commercial banks organized by companies limited by shares (CLSs) in private transactions. Past equity investments in commercial banks are approved by the State Council on a case-by-case basis. After Bank of China has ceded supervisory responsibility over commercial banks to the China Banking Regulatory Commission (CBRC), the newly established agency will likely continue to limit aggregate foreign ownership to 25% in one entity, and a 15% limit on individual investor (Howson & Ross, 2003). In addition, PRC authorities might be more willing to cede minority participation to non-strategic partners who are less likely to dominate the smaller Chinese financial institutions.

**Strategy, Structure and Rivalry**

In contrast to the increasing incidents of alliances between foreign banks and small- or medium-sized commercial banks, nothing is yet to be done with the four biggest state-owned banks: Bank of China, China Construction Bank, Industrial and Commercial Bank of China and Agricultural Bank of China. Even though Bank of China can be acquired for a 5-10% stake at a likely 1-2 billion, no foreign investor has shown interest. The deterring forces are both political and financial. Given the political significance of the above-mentioned four state banks to the Chinese government, foreign banks often believe that there is no prospect of ever gaining board control even after the removal of limitations on foreign majority ownership in state banks (Howson & Ross, 2003). In addition, the “Big Four” banks had outstanding non-performing loans (NPL) amounting to 1.99 trillion yuan (US$239.76 billion) in the end of September 2003, a NPL ratio of 21.4% that is beyond the acceptable standard of foreign banks (Dong, 2005). However, a majority of corporate and deposit accounts still lie in the hand of these “Big Four” banks. Even if the foreign banks want to shift away from corporate-banking to credit cards and wealth management businesses, they could demonstrate far more growth with
the extensive consumer base and wealthy depositors from the top four banking institutions. Despite the difficulty of acquiring minority stake in these four banks, much is to be anticipated on the possibility of a business or strategic alliance between a foreign bank and one of the leading state banks.

In pursuing success in the strategic fit of the acquisition, the combining firms ought to examine the commonality in their performance and strategic attributes. The combined businesses should also strive to have compatible culture, management styles, ability to implement changes and good quality of corporate governance (Chen & Findlay, 2003). As foreign firms strive to outperform their rivals in the Chinese currency market, the potential for success lies in how each foreign firm can successfully integrate its own standards into the domestic system, so that the local banks can dramatically improve the efficiency of distribution channels, quality of customer service and standards of risk assessments. The Chinese government’s dedicated reforms in the banking sector would also facilitate the likelihood of strategic and organizational fit, with the introduction of systems for bank loan classification, recapitalization of the four state commercial banks and restrictions aimed at getting banks out of stock market speculations.

Conclusion

Given current restrictions on foreign majority ownership in local banking industry, acquiring minority stakes in various Chinese local banks has placed many foreign banks at a strategic advantage in exploring the regional potentials in the currency business, asset and insurance management, consumer banking, and credit card businesses. Despite the obvious attractions of the Chinese market, it remains largely uncertain to what extent China’s weakness in corporate governance regulation and long-standing problem in NPL will compromise the prospective gains of the foreign acquisitions. On the other hand, scholars and foreign investors remain hopeful that cross-border M&A in China can play a positive role in promoting the economic restructuring of the host economy (Chen & Findlay, 2003).

Therefore, acquisitions in Chinese banks should not be made with the short-term goal of making capital gains from buying an undervalued Chinese asset. An under-developed capital market means that stock prices tend not to fully reflect the market value of the firms. Chinese appraisers tend to base their valuation on replacement value less depreciation, leading to gross overvaluation of the firms. Other than overvalued assets, the benefits of foreign stake in the Chinese banking business could only translate into reality if the country can cash in on its promises on economic restructuring and credit assessment. The foreign investors are in for the long term, a very long term. As one observer remarks on the strategy of HSBC, the London-based banking institution is one of the few banks that can make “piecemeal-type of minority shareholdings, and wait a generation for it to turn into real money.” (Dolven et. al., 2004)

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The Future of ASEAN’s Economy: Growth through Foreign Direct Investment

By: Thummim Cho

The difference between Foreign Direct Investment (FDI) and other types of cross-national investment exists in that FDI grants the investor control over the acquired asset [those investors are often referred to as ‘multinational enterprises’ (MNEs)]. FDI is useful because it not only overcomes the limitation of domestic funds, but also increases the country’s productivity by introducing new technologies, management strategies, and labor practices. For those reasons, FDI often works to drive high GDP growth in developing countries such as those who are members of Association of Southeast Asian Nations (ASEAN). This article will examine the relationship between FDI and economic growth, the role of economic integration in attracting FDI, and the development of integration within ASEAN to draw a conditional conclusion about the future of ASEAN’s economy.

FDI and economic growth

More evidence suggests that FDI contributes to high economic growth in developing countries. In the neoclassical perspective, FDI increases capital stock per efficient labor unit in an economy not in steady state, inducing short run economic growth. The effect is more significant in less developed economies since it tends to yield higher marginal product of capital. A recent study (Alfaro, 2001) empirically examined the direct effect of FDI on economic growth using the Ordinary Least Squares method to estimate the following cross-section regression model:

\[
\text{Growth}_i = \beta_0 + \beta_1 \text{FDI}_i + \beta_2 (\text{FDI} \times \text{FINANCE}_i) + \beta_3 \text{FINANCE}_i + \beta_4 \text{CONTROLS}_i + \nu_i
\]

Based on a sample of 39 countries from 1981-1997 with a fair representation of various economies in terms of GDP per capita and FDI level, the coefficients on FDI ranged from 1.12 to 1.42 depending on the different sets of control variables. The result supports the hypothesis because positive coefficient denotes positive relationship between FDI and economic growth.

The contribution of FDI to economic growth is greater for ASEAN than other economies because a large part of ASEAN’s international trade has been conducted through multi-national companies (Mahani, 2004). According to Fan and Dickie (2000), FDI’s contribution to ASEAN GDP growth increased from 4 percent in 1987 to more than 20 percent in 1997, suggesting that FDI is an important determinant of GDP growth especially for ASEAN.

Indeed, both GDP and FDI of ASEAN5 (the five original member countries: Indonesia, Malaysia, Philippines, Singapore, and Thailand) had risen dramatically during the late 80s to mid 90s. The 1997-98 Asian crisis led to stagnation of both FDI and GDP growth.

To extrapolate what stimulated rapid growth of FDI between the late 80s and mid 90s, it is necessary to examine what major changes took place in ASEAN during the time period. A noteworthy movement during the interval is that ASEAN launched and began to carry out the plans for economic integration.
**Integration as a driving force of FDI**

An ideal economy for FDI should offer the package of big market, low production cost, high productivity, and more flexible legal system regarding foreign investment. ASEAN economic integration is an important determinant of FDI for that reason. It cuts costs across the production value chain so that MNEs can do business with lower cost across the borders within ASEAN, allowing the MNEs to use the cheapest inputs and the best workers in production. A case study in the electronics sector done by Schwarz and Villinger (2004) suggests that increased regional integration could cut the costs of companies by 10 to 20 percent. Therefore, it seems logical to examine the development and future of ASEAN integration to predict the future of FDI in the ASEAN’s economy.

ASEAN has clearly pursued integration. Established in 1967 with five founding members—Indonesia, Malaysia, Philippines, Singapore, and Thailand—and joined later by Brunei, Laos, Cambodia, Myanmar, and Vietnam, ASEAN has regarded economic cooperation and liberalization as one of its important goals. Recognizing that little economic interactions were taking place among the member countries, ASEAN in the 70s began to address the situation through economic cooperation schemes such as the Preferential Trading Arrangement of 1977, aimed at tariff preferences for intra-ASEAN trade.

ASEAN geared up its integration effort at the Third ASEAN Summit in Manila in 1987 by adopting an Enhanced PTA Programme. In 1992, it launched a scheme toward an ASEAN Free Trade Area Agreement (AFTA) as well as some other measures through the Framework Agreement on Enhancing Economic Cooperation adopted at the Fourth ASEAN Summit in Singapore. Five year later, the ASEAN leaders implemented the ASEAN Vision 2020 to stimulate economic integration within the region. The purpose of AFTA is to “increase the ASEAN region’s competitive advantage as a single production unit” (ASEAN Secretariat, 2004) by removing tariff and other barriers among the ASEAN countries to achieve greater economic efficiency, productivity, and competitiveness. The Common Effective Preferential Tariff (CEPT) schedule has worked as the implementing mechanism for the AFTA. (The ASEAN Secretariat, 2004). Trade and investment liberalization is not the only way of pursuing economic integration. According to The ASEAN Secretariat (2004), ASEAN is also promoting trans-ASEAN transportation network, the interoperability and interconnectivity of the national telecommunications equipment and services, and trans-ASEAN energy networks.

Two simple measures of economic integration show that ASEAN’s economy has been integrating. According to catching hypothesis, as economies integrate, the countries with lower initial income and productivity levels benefit as information and technology transfer from the developed countries, thereby raising the productivity without paying the cost of research and development. That way, the less developed economies catch up with the more developed countries, a tendency manifested through higher GDP growth of the latter. The graph suggests that like the other cases of integration, the less developed economies in ASEAN (Cambodia, Laos, Myanmar, and Vietnam) have experienced much higher GDP per capita growth than ASEAN6 (Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand), which in contrast experienced negative growth due to the 1997 crisis and the 2001 economic slowdown.

Growth in percent of intra-regional trade as a percentage of the region’s total trade is also a good measure of regional integration because economic integration tends to raise trade within the region compared to total trade. From 1993 to 2003, trade within the 10 ASEAN economies as a percentage of the economies’ total trade had risen by 3%. Although data was only available from 1993, The ASEAN Secretariat (2004) indicates that the figure in the early 70’s was 12-5%. This suggests that for the thirty years, the figure has risen by 7-10%, implying that the average rate of growth from 1993 to 2003 is likely to be lower than the rate of integration during the 80s since the rate must have started to significantly rise at least after the first movement towards integration in 1977.

**Foreign Direct Investment and Economic growth**

![Graph showing GDP per capita growth rate and amount of FDI in USD million from 1981 to 2003.](image)

Sources: Economist Intellectual Unit DataServices and Penn World Table
value (or the goodness of fit), meaning that it might explain the time-series variation in the intra-ASEAN trade rate better than the line based on linearity does. This implies that there are some obstacles to deeper economic cooperation.

One of the biggest problems is that the member nations are politically unwilling to pursue full integration, putting off liberalization plans to protect domestic industries. Since 2000, some countries have deferred their tariff reduction commitment under the CEPT scheme to protect its industries. For instance, fearing that its automotive industry would not survive liberalization of the industry, Malaysia has asked to delay tariff reduction for the ‘sensitive sector.’ Also, in response to the global abundance of steel production in 2002, Malaysia increased its tariff rates for steel from 25 to 50 (Mahani, 2002).

Consumer prices of ASEAN countries are also not diverging when it is natural for prices among the integrating economies to diverge and fall, for the lowest price supplier of certain good exports to the other member countries. Analyzing the cost of 70 common household products, Schwarz and Villinger (2004) concluded that the prices still varied significantly among the ASEAN economies, suggesting that the creation of a large, unified consumer market is not taking place in the region. The tendency must have discouraged FDI because companies cannot market goods for the whole consumer market.

**Evidence of Catching Up**

Average Growth Rate of GDP

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<tr>
<td>Less developed ASEAN</td>
<td>4%</td>
<td>1%</td>
<td>2%</td>
</tr>
<tr>
<td>Ireland, Portugal, Spain</td>
<td>3%</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td>France, Germany, UK</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
</tr>
<tr>
<td>Mexico</td>
<td>6%</td>
<td>7%</td>
<td>8%</td>
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Sources: Mckinsey Quarterly; ASEAN Finance and Macroeconomic Surveillance Unit

The other factors of FDI are showing positive signs. According to the data of Economist Intelligence Unit, the rate of labor productivity increase of ASEAN has been greater than the average. For example, that of Vietnam has grown by approximately 10% every year. The major export industries of ASEAN are global high-growth sectors (Schwarz and Villinger, 2004). ASEAN also has established a number of Free Trade Areas (FTAs) with non-ASEAN countries, such as the ASEAN-China FTA, to pursue external liberalization. Some countries, notably Singapore, are pursuing bilateral arrangements as well (Mahani, 2002). These efforts will make ASEAN more accessible for foreign investors, thereby attracting more FDI. Therefore, there seems to be enough evidence to draw this conditional conclusion: given that the member countries carry out the project as planned, inward FDI rate of ASEAN will be back on track, resulting in higher economic growth of ASEAN in a number of years.

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Online Auctions: Changing the Face of Game Theory

By: Dan Tevet

With the advent of the Internet in the past decade, the popularity of online auctions has exploded. These auctions differ quite a bit from traditional English auctions, requiring the creation of new game-theoretic models.

Until about ten years ago, the average person seldom, if ever, participated in serious auctions. Though casual charity auctions were always common, these noncompetitive auctions needed no game theory analysis. The logic of an auction seemed simple to most – to keep bidding on the most coveted item until the price exceeded what he is willing to pay. The only true competitive public auctions occurred in Sotheby’s-style houses, where rich patrons would gather to hear a fast-speaking British auctioneer attempting to sell pretentious artwork. These “Going, Going, Gone” auctions were believed by many to be the only type.

How the times have changed. The advent of the Internet in the past decade seems to have drastically changed the perception of an auction. With the plethora of online auctions currently available, anyone can become an avid bidder. This explosion in auction participation, coupled with the fact that online auctions differ greatly in form from live auctions, has led to great demand for game theory models. Though there are many interesting topics to address, I will focus on two: second-price auctions and sniping in online auctions.

The vast majority of auctions prior to the era of the Internet were simple first-price auctions. In this plain and simple style, the item is given the highest bidder at his or her winning bid. By contrast, in a second-price auction (also known as a Vickrey auction), the item is given to the highest bidder at the amount of the second highest bid. Though this method may seem strange and pointless, it incorporates the major principle of the game theoretic dominant strategy, where each participant bids his or her value of the item.

To show why second-price auctions are so theoretically attractive, consider the simple case of two bidders. Let $v_1$ be the value of the item to Bidder 1, $v_2$ be the value of the item to Bidder 2, $b_1$ be Bidder 1’s bid, and $b_2$ be Bidder 2’s bid. Assume that each player knows how he values the item, but does not know how the participant values it. First, take the case where $v_1 > v_2$. Assume Player 1 bids $v_1$. If Player 2 bids $b_2 < b_1$, she does not get the item and pays $v_1 - v_2 = 0$. If $b_2 > b_1$, she gets the item and has a payoff of $v_2$. Thus, if $v_1 > v_2$, Player 2 can do no better than to bid her value, assuming Player 1 bids his value.

Now take the case where $v_2 > v_1$. Assume Player 1 bids $v_1$. If Player 2 bids $b_2 < b_1$, she does not get the item and has a payoff of $v_1 - v_2$. If $b_2 > b_1$, she gets the item and has a positive payoff of $v_2 - v_1$. Thus, if $v_2 > v_1$, Player 2 can do no better than to bid her value, assuming Player 1 bids his value.

To examine the case where $v_1 = v_2$, assume the two players bid the same amount ($b_1 = b_2$). In that situation, the item will either go to Player 1 or Player 2, each with an equal probability of winning the bid at 1/2. Again, assume that Player 1 bids his value ($b_1 = v_1$). If Player 2 bids $b_2 < b_1$, she does not get the item and has zero payoff. If $b_2 > b_1$, Player 2 gets the item and pays $v_1 - v_2 = 0$, for it. If she bids $b_2 = b_1$, she would get the item with probability 1/2 and not get the item with probability 1/2. Thus, her payoff in either case is zero. In conclusion, if Player 1 always bids his value, Player 2 can do no better than to bid her value and the opposite argument clearly holds by symmetry. Thus, in a second-price auction...
auction, the dominant strategy is to always bid your value.

Though second-price auctions are more theoretically attractive than first-price auctions for the reasons aforementioned, second-price auctions have significant limitations. Mainly, in an open auction, there are no barriers to prevent someone from initially bidding an obscenely high price (say $20 million dollars for an iPod). Since the second highest bid would be zero, the quickest bidder would get the item for free. Though second-price auctions succeed in a closed-bid system due to the possibility of someone else having the same strategy, they do not work in open-auctions, or at least, not in pure form. However, a close derivative of second-price auctions is used by many auction websites such as www.ebay.com and www.bigredexchange.com.

The key aspect of many online auction websites, which makes their style similar to that of a second-price auction, is the use of software bidding agents. A user simply tells the bidding agent how much he is willing to pay for the item and the agent keeps increasing the bids by the minimum bidding increment until either no one else is bidding or the user’s maximum price has been met. Thus, the item goes to the highest bidder at the value of the second-highest bid plus the minimum bidding increment, at least in theory. As a result of this system, second-price auctions, once rarely used, are now profusely utilized millions of times each day, though the users seldom realize it.

While the use of second-price auctions is a significant change in auction theory brought about by the explosion of Internet auction sites, the biggest difference between online auctions and live auctions is the possibility of “sniping.” Almost all live English auctions (real-time ascending-price auctions) are soft-close, meaning that the human auctioneer closes bidding once no one else is willing to bid. In comparison, a hard-close auction has a fixed stopping time, in which only bids submitted before the close are counted. Most online actions are hard-close, leading to the possibility of what has been termed sniping. Sniping involves posting a relatively high bid at the very last seconds before the auction closes. Since the other participants wouldn’t have time to react, the sniper could win the item at a non-competitive bid.

In theory, the use of software bidding agents should nullify any threat of sniping, but the situation is not as simple in practice. In a recent analysis of 1000 completed eBay auctions, 28% had zero bidders and 16% had exactly one bidder. Of the remaining 56% with multiple bidders, 74% showed multiple bidding (meaning that a bidder raised his reserve price at least once amid the auction) and 18% showed bidding in the last 60 seconds before the auction closed. These results suggest that sniping, in practice, is not as trivial as theory would suggest.

The main reason for the success of sniping is probably asymmetric information. As is common in economics, auctions have an equilibrium if we assume perfect information, but the introduction of asymmetric information quickly leads toward disequilibria. People bidding on an item may not know its value or be fooled by lower bids. Take, for example, a ticket to a sporting event that I initially am willing to pay $40. However, several hours before the auction closes, the maximum bid is only $10. I then believe that I may have overestimated the value of the ticket, so I only authorize my bidding agent to bid up to $30. Then, last minute, a sniper bids $35 and wins. Thus, fear of the winner’s curse (the possibility that the winner won because he overvalued the item), may be the primary impetus for sniping.

Though auction sites have taken much criticism for allowing sniping, eBay, as well as Cornell’s own bigredexchange.com, maintain that sniping is all part of the game. In fact, one can argue that the possibility of sniping is more likely to push an auction toward equilibrium. If everyone were to initially enter his true value into the software-bidding agent, sniping would not be a problem at all. Hence, the threat of being sniped forces bidders to think hard about how they value the item. Still, this analysis assumes perfect information among bidders.

One major auction site, Amazon Auction, has taken steps to prevent sniping. If a bid is entered on an Amazon Auction within the last minute before close, the auction is automatically extended by ten minutes to allow the other bidders to rethink their valuation. There has been pressure on eBay to follow suit, but only time will tell whether or not this practice will be followed.

In summary, competitive auctions, once inclusive only to rich patrons and business executives, are now accessible to anyone with Internet connection. Since the old generation game theory models, employed to analyze auctions, mostly apply only to first-price English auctions, they must be revamped to apply to current online auctions. Also, new models must be created to analyze such phenomena as sniping, which was largely unheard of before the Internet auction explosion. However, the best way to understand an online auction is simply to participate in one. For more information about participation in the Internet auction craze, I encourage you to visit www.ebay.com. Even better, if you’re a Cornell student, visit Cornell’s own auction at www.bigredexchange.com.

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Spring 2005
Behavioral Economics: A Look into this New Course and Professor O’Donoghue

By: Tulika Kumar

Behavioral economics, an up-and-coming field of economics that integrates aspects of psychology and other social sciences, is finally being taught at the undergraduate level by Professor Ted O’Donoghue. The course, Economics 358, specifically aims to question the standard models and assumptions made in economics by showing that human behavior does not always fit such traditional ideas. With a goal to modify these standard models and learn about newer ones that incorporate more realistic assumptions about human behavior, this course assesses whether these modifications and interpretations improve economic analyses.

Professor O’Donoghue plans to cover four main topics in Economics 358: prospect theory and its applications, hyperbolic discounting and self-control problems, altruism and social preferences, and errors in information processing and biased perceptions. Real-world applications including 401K retirement decisions and questions about full versus partial insurance will be discussed with respect to behavioral economics.

In a previous lecture, Professor O’Donoghue addressed a classic time preference experiment. He asked students if they would prefer $10 now versus $10 next week, $10 now versus $11 next week, $10 now versus $12 next week, and so on. The same question was posed for a one-week delay so that he was asking $10 now versus $10 two weeks away, $10 now versus $11 two weeks away, and so on. The standard result shows that people tend to be more impatient when thinking about now versus next week than when thinking about a one-week delay in the future. Data from the class supports this conclusion, although very weakly. The notion of impatience, as well as anticipation, anxiety, self-interest, and loss aversion, are just a few of the many examples of human behavior that affect standard models.

As an undergraduate at Dartmouth College, Professor O’Donoghue found a strong liking for psychology and economics. When he applied to graduate school, he wanted to combine the two fields. He went on to complete his dissertation at the University of California, Berkeley, where he researched patent design. Towards the end of his graduate career, he was able to pursue the mix of psychology and economics with Matthew Rabin, with whom he wrote many papers. Professor O’Donoghue says that going into academics has allowed for his “love for the twin components of teaching and research.” Currently, Professor O’Donoghue is co-authoring a paper about projection bias, when individuals project current feelings to the future. Specifically, he, along with Professor Vogelsang and Professor Michael Conlin at Syracuse University, will examine orders of winter clothing items in catalog companies. They will explore how the propensity to return an item depends on...
the outdoor temperature.

While behavioral economics has been taught at the graduate level by Professor O’Donoghue (Economics 758), the economics department never included a course for undergraduates until this semester. Economics 358 is not only a brand new course for Cornell, but it is also new for Professor O’Donoghue. When asked about the challenges he faced while designing the course, he noted that it was difficult “trying to put together a course that is coherent,” especially without a textbook. The course is designed so that students learn everything they need to from lectures and some supplementary articles. Professor O’Donoghue also realized in order to show how behavioral economics questions standard assumptions and models, he would actually have to first teach these standard notions. As a result, he usually devotes some time to understanding standard economic models, throws some twists and turns into them, and shows how a newer model that incorporates human behavior may explain real-world settings in a better fashion.

An interesting feature of the course is that it is designed in a very flexible manner. No matter what, homework will count for 30% and exams for 70%. How the 70% is allocated is what is unique to this course. Depending on each student’s individual performance on the exams, he weighs the exams differently for each student. The two prelims can be 15% each with a 40% final, or 25% each with a 20% final.

For students who are interested in taking Behavioral Economics, he suggests a good way to get a general overview of the course matter is to take a look at a book written by Richard Thaler called “The Winner’s Curse: Paradoxes and Anomalies of Economic Life.” The book documents anomalies inconsistent with standard economic models. According to Professor O’Donoghue, it is very accessible at the undergraduate level. The prerequisites for the course include Intermediate Microeconomic Theory (as taught in Economics 313 or 301) and some knowledge of calculus.

For his current students, when asked for tips on how to do well on the final exam for Economics 358, Professor O’Donoghue advises, “Be calm. Think first, then write.”

Overall, the course seems to be very different from other upper-level economics classes. It has numerous real-world applications and Professor O’Donoghue has a unique and fun approach to the class. As for his personal goals for the course, he says, “what I hope to get across most is to illustrate the beauty of the economic way of thinking” since specifically behavioral economics shows “economics at work.”

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Interview with Professor Ted O’Donoghue – Thursday, March 3, 2005
Class website – http://instruct1.cit.cornell.edu/courses/econ358/

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