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DER TAGESSPIEGEL

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FROM THE CEO

In 1998, the Milken Institute had an idea: what if we brought together serious, influential people with widely varying backgrounds, but a shared desire to address the world's most pressing challenges? From that acorn has grown a mighty oak in the form of the annual Milken Institute Global Conference, which in 2017 marks its 20th year.

This year, the event will bring 3,500 participants to Los Angeles from 50+ countries for nearly 200 panels and private sessions over four days of intense activity. The wealth of discussion, the diversity of our panelists and the relentless focus on issues crucial to the future of the planet have made the Global Conference a vital meeting place for those with the mind and the means to make a difference.

From early on, the topics at the conference have included:

• The impact of revolutionary changes in technology on the economy – and on our lives.

• The promise of biotech and advances in medical research.

• How best to create well-paying jobs that sustain and grow the economy.

• Educational innovation that keeps America innovative and productive.

• How to create a financial system that works for all.

Some of my favorite recollections of the Global Conference are the moments when presumed opponents have found common ground. Once, then-House Majority Leader Eric Cantor and then-Senate Majority Leader Harry Reid shared a stage and discovered that they agreed on much. Or the time former Vice President Al Gore jauntily dodged a question by hugging his co-panelist then-Fox News chief Roger Ailes.

But even more satisfying are the moments when connections made at Global Conference led to concrete steps that improved lives. I remember the prominent executive who, after learning about the deadly impact of a tropical disease, invested considerable time and resources to conquering it. Or the alternative energy producer from Israel who met representatives from Rwanda, leading to that country's first solar energy initiative. Or the investment banker who, inspired by the presentation of Nobelist Muhammad Yunus of Bangladesh's Grameen Bank, became the founding president of Grameen America, to bringing micro-lending to the United States.

I am often asked what makes the Global Conference unique, and why has it become such a success. The answer to both questions – in part, at least – is that, since its beginning, the conference has emphasized moderated discussion among panelists with varying views. That's not only the best way to ensure lively, substantive exchanges, it's a metaphor for a core conviction driving the larger enterprise of the Milken Institute: the best solutions are found when people with different perspectives collaborate to find solutions to problems that affect us all.

Mike Klowden

Michael Klowden, CEO

Our ever-loyal reader JG of Passadumkeag, Maine, writes to ask why we never publish queries from other correspondents in this space. Good question, JG! Cynics would say it gives us a chance to repeat the charming name of your hometown ad infinitum. But that would be beneath our dignity. And in any event, Passadumkeag's reign may be ending: we just got mail from a fan in Carne Assada, Portugal, who wonders why everybody misspells the name of her town.

Enough food for thought. Some of our readers are itching to know what we've got lined up in this issue.

Alan Krueger, President Obama's former chief economist, takes aim at barriers to competition in labor markets that sap productivity, even as they reduce both wages and employment. "Countering anti-competitive employer behavior could be a win-win for the economy," he writes. "But it would take a fundamental shift in perceptions – one that is a hard sell in an America seemingly disinclined

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to look closely at how everyday labor practices undermine workers' prospects for moving up the income ladder."

Nick Eberstadt, a political economist at the American Enterprise Institute, ponders the consequences of the great exodus of men from the American workforce, and brainstorms ways to bring them back. "The progressive detachment of ever-larger numbers of adult men from the reality and routines of regular paid labor can only result in lower living standards, greater income inequality, higher social-welfare bills and larger budget deficits," he writes. "The first priority is to bring this invisible crisis out of the shadows and into the glare of public scrutiny."

Ramona Bajema, a Japanese historian, returns to Fukushima six years after the tsunami and the subsequent nuclear power disaster that killed 20,000 and left the Tôhoku region to face a grim future. "No amount of earth moving and concrete pouring is going to fix what ails," she writes. "What Tôhoku needs most now is help in adapting to rapid economic and demographic dislocation. And that is not an easy sell in a contemporary Japan that's struggling with all manner of unwanted change."

Ed Bartholomew, a pension consultant who was the CFO of the Inter-American Development Bank, explains why the looming pension liabilities of states and localities are far worse than the officials in charge acknowledge, or apparently even understand. "Future retirees are in the uncomfortable position of depending on contractual rights that may require courts to enforce – a position made more uncomfortable by the fact that millions of them don't have Social Security as a backstop," he explains. "It's human nature to delay difficult decisions, especially if the current generation of deciders can dump the decisions on the next. Figuring out how we got in this pickle, alas, is much easier than whacking a pathway out."

Charles Castaldi, a former foreign correspondent for NPR, samples Germans' reaction to Angela Merkel's decision to take on the mantle of moral leadership eschewed by the United States in the Syrian refugee crisis. "Germany's open door came at a steep cost," he writes. "First, the direct financial outlay ran to $23 billion – just in 2016. And then there's the political cost. Most polls show that over half of Germans view the refugee issue as the most serious problem Germany faces today."

Jacob Udell and **Glenn Yago**, of the Milken Innovation Center at the Jerusalem Institute for Israel Studies, revisit the problem of constructing a viable Palestinian economy from the ruins of permanent war. "Developments on the international stage have a way of distracting from solutions to pressing fiscal, trade, environmental, business and infrastructure issues that could improve daily life," they write. "It would serve neither Israelis nor Palestinians to cling single-mindedly to the goal of European-Union-style integration. Normalization of economic relations between Israel and an independent Palestinian state will surely depend on an agreement that facilitates trade and capital flows, but that need not imply full integration of labor or capital markets."

That's not all, folks. In a chapter from their new book, *Beating the Odds*, **Justin Yifu Lin** and **Célestin Monga** argue that development economics requires a thorough makeover to bring lagging nations into the mainstream. The eminent demographer **Bill Frey** explains why U.S. population growth is heading for zero. And your humble editor investigates whether *The Economist* magazine's Big Mac Index is a reliable guide to international differences in the cost of living. Browse wisely, my friends.

— *Peter Passell*

ALEC:
Headline is "Population Growth Hits Bottom"
Caption for Home page is: "But there's a silver lining."
Main topic: Demographics
Other topics: Immigration
Home page and main article page: use the Charticle general image.
Use the image on this page for the dedicated article intro

CHARTICLE

BY WILLIAM H. FREY

The United States hit a new low in 2016. No, I am not talking about the raucous, divisive election. It's the demographic nadir we reached, as population growth slowed to just 0.69 percent – the lowest since the Great Depression. That's down from a peak of 2.1 percent in 1950, when the post-World War II baby boom was in high gear.

The marked decline over the past decade was tied to one short-term factor – the blowback from the 2007-9 recession – and the long-term reality that America is aging. The recession exerted a double whammy, slowing immigration and narrowing the difference between births and deaths. Immigration has largely recovered, but not the natural increase. Some of the recent fertility decline could prove temporary, though, a recession-related delay in family formation among young millennials.

The mortality trend, by contrast, is here to stay. And in the decades ahead, population aging will also lower fertility rates. By 2040, the Census Bureau projects annual growth will sink below 0.5 percent.

That figure will still dwarf the rates in most other rich countries. Some, including Japan, Germany and Italy, have already entered negative population growth territory – though Germany may get a temporary boost from its uniquely generous policy toward refugees (*see page 8*).

BILL FREY is a senior fellow at both the Milken Institute and the Brookings Institution, and author of *Diversity Explosion: How New Racial Demographics Are Remaking America*.

If there's silver lining in the recent numbers, it's the recovery of domestic migration as victims of the Great Recession again see their way clear to chasing a better life in Sunbelt states. Utah (aided by high Mormon fertility rates) tops the list with growth above 2 percent. But Nevada, Idaho, Florida, Washington, Oregon, Colorado and Arizona are all growing faster than 1.7 percent.

Of course, internal migration is a zero-sum game: for the first time since the 1980s, eight states registered population losses, most notably New York and Illinois. But a restless citizenry is a hallmark of American particularism, and a return to higher migration levels – when they're voluntary, anyway – has to be seen as a plus.

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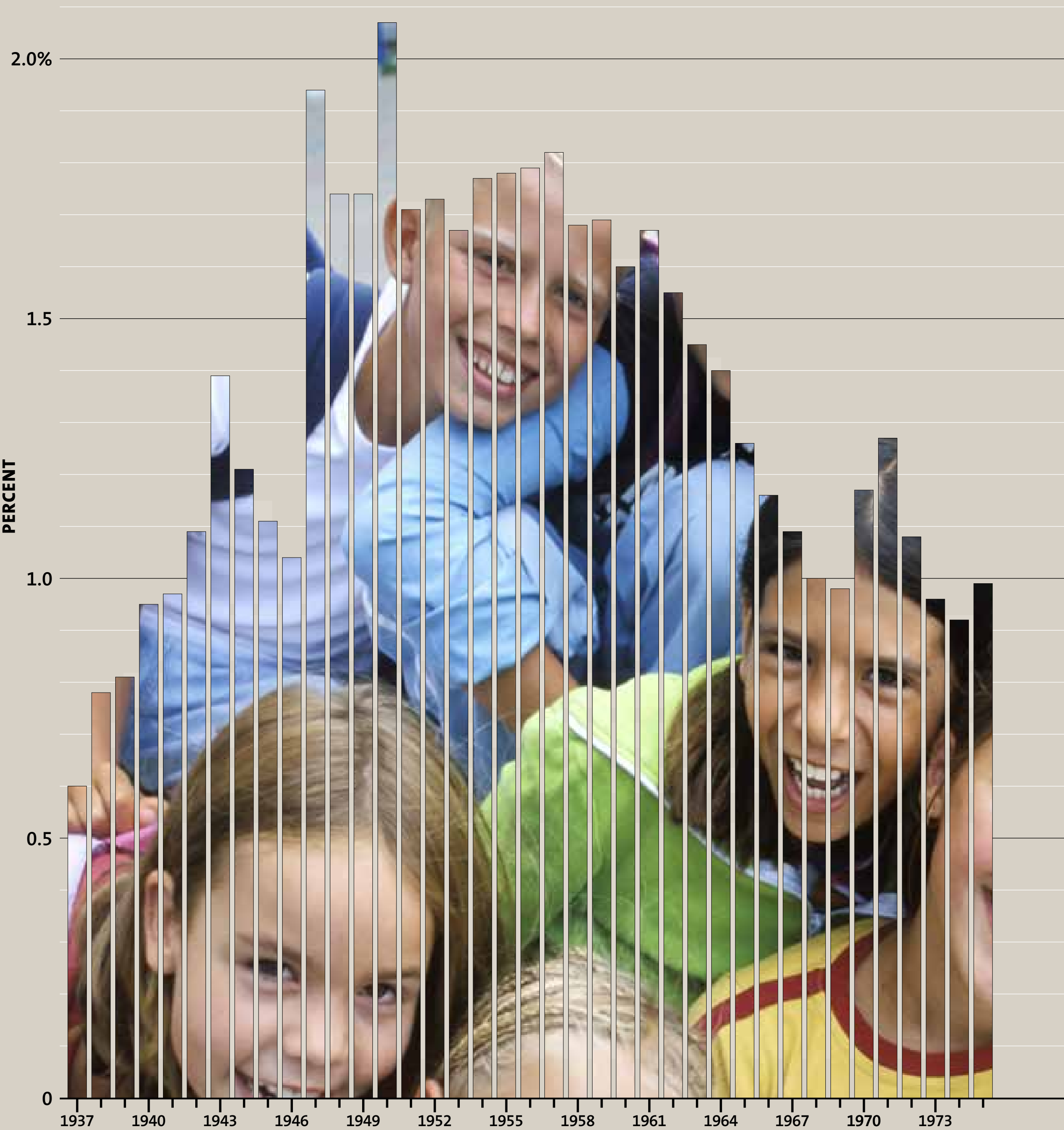
U.S. ANNUAL POPULATION GROWTH, 1937–2016



SOURCE: William H. Frey analysis of U.S. Census Bureau historical population estimates

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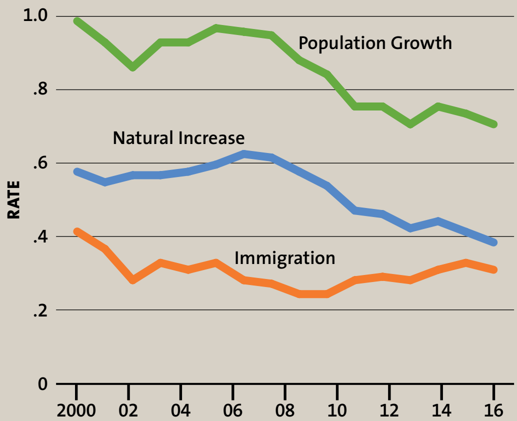
RATES OF GROWTH

NATURAL INCREASE AND IMMIGRATION, 2000-2016



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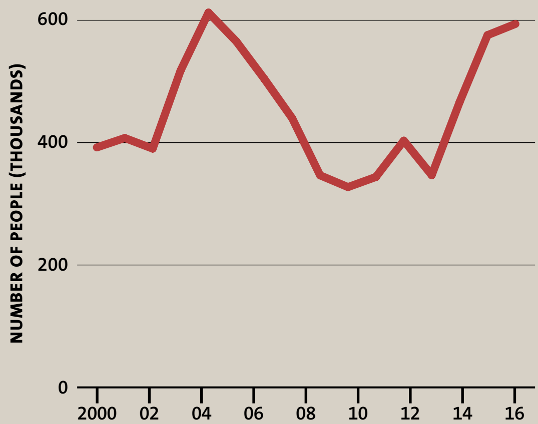

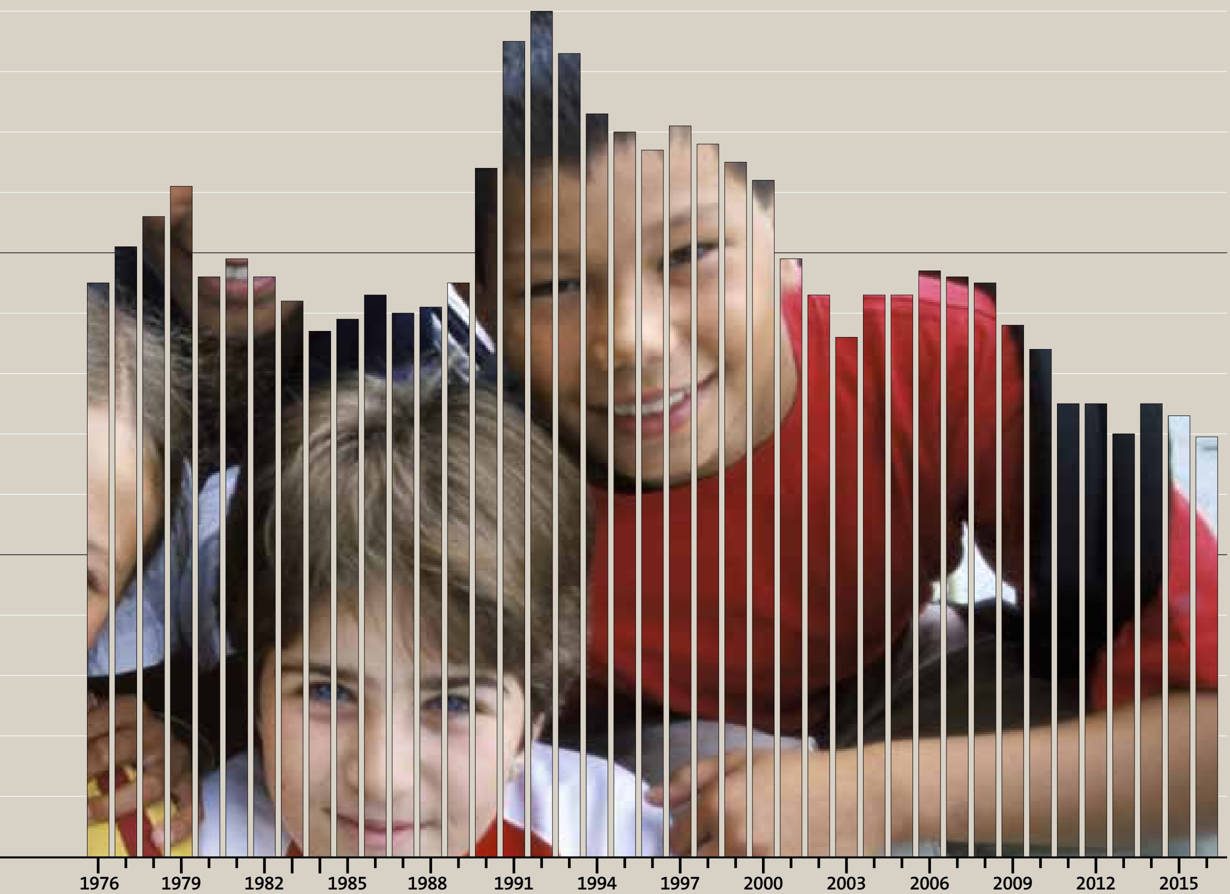

review

LETTER FROM GERMANY

BY CHARLES CASTALDI

ALEC:
Headline is “Letter from Germany”
Caption for Home page is: “It’s hard to do the right thing”
Main topic: Europe
Other topics: Immigration, Human Capital

er East Berlin stands as a monument to a nism – not to mention as a symbol of the contradictions that abound in modern Germany. A building as imposing as it is plain, it housed thousands of agents who kept track of East Germans at a mind-numbing level of detail. After the Stasi files were opened, the scope of the surveillance was revealed: it seemed almost the entire East German population was spying on itself.

WOLFGANG KUMM/AFP/GETTY IMAGES

On the top floor of the principal building, I walk through a metal door constructed to thwart electronic eavesdropping and into the office of Markus Wolf, the mythical spy known as “the man without a face.” Widely considered one of the most effective spies of all time, he was only identified following the reunification of Germany, after which he managed to avoid any meaningful prison time. He subsequently embarked on a writing career that included (along with his memoirs)

CHARLES CASTALDI, a former NPR correspondent, is a regular contributor to the *Review*.

Secrets of Russian Cooking, in which he drew a parallel between the culinary arts and espionage. Needless to say, both the Russians and the Germans are better known for the latter.

Looking out the window onto the courtyard nine floors below, I can see children playing soccer. They scream for the ball in Arabic and Pashtun: the Stasi building has been turned into a refugee shelter.

The symbolism is not lost on Hartmut Zick, a 50-something ponytailed native of Berlin who manages this center. "We saw the misery, the need," he says. "To be able to use this building, of all places, made it especially significant." The building had been unoccupied until a benefactor bought it from the city for one euro and, instead of turning it into a condo, transformed it into a refugee shelter.

DER TAGESSPIEGEL

We wander through corridor after corridor of offices that now serve as tiny apartments for four. There are classrooms for German lessons, and art projects on the walls. The languages – and the faces – reflect the huge and varied human wave that has swept over a largely unprepared Europe over the past few years.

"Right now we have around 1,000 refugees housed here," Zick notes. His tone is matter of fact, but it's clear this is an arduous undertaking. And over the past few years, I've run into a surprisingly large number of people prepared to make similar commitments all over Germany. When they were confronted with "the pain and the problems of the refugees, we knew we must help," Zick says.

While other European countries have been generous, Germany is unique in the number of refugees it has accepted and the scale of the government and volunteer programs created to aid them. Of course, this has generated a backlash. But I was struck over and over again by the number of people willing to step up.

The refugee crisis grew to massive proportions in 2015, after Chancellor Angela Merkel declared that Germany would have an open-door policy and more than a million people took her up on the offer. The pictures of people dying by the thousands in Mediterranean waters spoke of the desperation of those escaping wars and poverty. For many, Germany was the destination of choice for its strong economy and generous government support system. But it was hard to reach, protected by a ring of less-welcoming countries on its southern border.

Germany's open door came at a steep cost. First, the direct financial outlay ran to $23 billion – just in 2016. And then there's the political cost. Most polls show that over half of Germans view the refugee issue as the most serious problem Germany faces today. And even though Merkel's approval ratings have remained above 50 percent, her Christian Democratic Union lost ground in Berlin state elections in 2016 to the Alternative for Germany, a right-wing party headed by Frauke Petry. Petry's platform, beyond pulling Germany out of the EU, focuses on closing the door to more refugees, particularly those from Muslim countries. Sound familiar?

Merkel, who is sometimes referred to as "leader of the free world" in the wake of President Trump's election, is, at this point, the key player in keeping the European Union together.

There's some irony here: a few years ago she was widely condemned for destabilizing the EU by taking a hard line on the fiscal problems of Greece (and Portugal and Spain and Italy). But she's since been openly critical of Trump's immigration policies and Vladimir Putin's efforts to divide the Western alliance, and she offered no solace to Brexit promoters who think they can convince the EU to maintain open trade with Britain once the U.K. jettisons open immigration. Merkel is still favored to be re-elected later this year. One can only hope that German pollsters are more accurate than their American counterparts.

Before leaving the Stasi building, I run into Diab, a 30-year-old refugee from Syria, who's come to visit a friend. Diab left Damascus alone in 2015 and made his way through Turkey, Greece and the Balkans before reaching Germany four months later. "Even when it looked impossible," he says, "I always told myself I would make it."

In a sense, Diab is lucky. He is educated, he worked as a banker, his family pitched in to help pay for his journey, which he says cost "many thousands of dollars." And he was able to find an apartment, which he shares with four other Syrian men, after spending only six months in the shelter. He studies German six hours a day – "such a hard language," he says – and hopes to get a master's in finance.

Diab is also Christian – something he kept secret in the shelter. "Most of the people here are Muslim," he says in a whisper. "They are very, very religious – very old fashioned."

Zick confirms this, adding that a great majority are from the poorer, less-educated strata of their respective countries. Indeed, part of what makes the refugee crisis so thorny is that ISIS is drawing recruits from the same strata. And even Germany now faces a very real threat from terrorists. Germans aren't likely to soon forget the Dec. 19 attack in Berlin by a Tunisian who drove a truck through a crowded traditional Christmas market, killing 12 and wounding 60.

WORMS

Over the past couple of years I've driven thousands of miles around Germany (which, on autobahns – a few of which still don't have speed limits – takes less time than you might suppose). After a while, the fact that it's one of the most developed countries in the world becomes manifest, whether in infrastructure that makes the United States look shabby or in renewable energy – wind turbines and

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solar panel arrays are to be seen everywhere. And just as obvious as what you see is what you can't see: poverty, which is not to say that it doesn't exist. But it's German poverty, a far cry from the American variety, because the German safety net is much more generous and encompassing.

What is less obvious until you travel off the beaten path a bit is that Germany remains a nation of small and midsized towns surrounded by a surprising amount of agriculture. Only four cities – Berlin, Hamburg, Munich and Cologne – have over a million inhabitants. Compare that to Italy, which has 10 cities with over a million, yet a total population that's 20 million smaller, and you get the picture. Indeed, it is a surprisingly bucolic picture, even if agriculture represents a mere 2 percent of GDP.

Interspersed in this mostly rolling landscape are midsized businesses – called *mittelstand* – that represent the backbone of the German economy. Sure, we all know about the Volkswagens and the Siemenses and their global market dominance. But smaller companies produce half of Germany's $4 trillion GDP and are credited with much of the robustness of the German economy.

I ran (literally) into an example in Worms, a picturesque town of 85,000 on the Rhine that vies with Trier for the title of oldest city in Germany. The Celts founded it, Romans built it up, Jews turned it into a cultural mecca and Luther took his stand against the Catholic Church here. Jogging out of the old city toward the Rhine brings me to an industrial area where I meet Timo Bernhard, who is monitoring a barge that is unloading ingots of what appear to be metal.

"Plastic," he corrects me drily, when I ask what the steel is for. Undaunted, I ask what the plastic is for. He eyes me warily and suddenly switches tone – which Germans will do if you appear either interested or completely clueless – and delivers a detailed description of the specialized plastics needed to make precision-machined plastic parts.

Bernhard and his brother own a small company with 34 employees that exports much of its output. "Nobody makes parts with such precision, such resistance," he says. "We are having to say no to many inquiries."

Both brothers learned their trade across the street from the docks where we're standing, as apprentices in Rochling Automotive, a much larger family-owned company that makes – you guessed it – plastic parts for cars. "We learned on the job, starting at the bottom," Bernhard says.

That is another keystone of the German economy, and *mittelstand* in particular: apprenticeships to produce a highly skilled labor force. I ask Bernhard if he has any workers who are immigrants. "Of course," he says. "Very good workers. From Turkey. Not like these ones coming in now, who just want the government to pay for everything."

When I mention Merkel, he frowns. "A big mistake," he says. "Letting in all these people. Most of them aren't educated. How will they get jobs?" I ask whether he'll vote for the anti-immigrant Alternative for Germany in the next election. He gives me a look, which I take to be my cue to leave.

Later that evening I am dining with Jutta Herbert, the pastor of Magnuskirche Lutheran church, where Luther himself is said to have preached. Herbert is a voluble woman in her 60s who explains that the challenge in Worms, which has taken in 400 refugees from Syria and North Africa, not to mention the challenge to the rest of Germany, is twofold: "We've had a Turkish community here for many years. They have been assimilating, especially the children. But it hasn't been easy for all of them.

"I didn't even vote for Merkel," she adds, "but after her courageous stand on the refugees, I am prepared to vote for her next time. Here in Worms, as in the rest of Germany, there are people who are against refugees and immigrants. That is why I use my pulpit to get out the word, to stay ahead of the curve."

But while many churches in Germany have been active in supporting refugees and building relations with mosques, the hard reality is that German natives are becoming less and less religious. And the churches, be they Protestant or Catholic, are struggling to attract young parishioners. "Ironically, I think the refugee crisis has served to get more people interested in coming to church," Herbert says. "They see this as a place where we can build community."

INVITED GUESTS

The Holocaust is the tectonic horror that underlies any discussion of assimilation or of German identity. What greater failure of assimilation could there be than taking a population of half a million of its own citizens who happened to be Jewish, forcing more than half into exile and exterminating the remaining 180,000?

After the war, Germany and its industries lay in ruins, but the combination of American cheerleading, currency reform and Chancellor Konrad Adenauer's careful economic management created what came to be known as the economic miracle. Construction of the Berlin Wall in 1961 and the restrictions it imposed on East Germans crossing to the West created a labor shortage. The German government turned to Turkey – not so surprising, since the Ottomans allied with Germany in World War I – inviting Turkish laborers to come to Germany as "guest workers."

While they were expected to remain only temporarily, it didn't turn out that way. Today,

MARTIN MEISSNER/ASSOCIATED PRESS

Today, about four million people of Turkish descent live in Germany. It's a relationship that remains fraught, and serves as something of a litmus test for how newer immigrants will fare.

about four million people of Turkish descent live in Germany. It's a relationship that remains fraught, and serves as something of a litmus test for how newer immigrants will fare.

I went to Berlin's Friedrich Eberts Foundation to talk to Dietmar Molthagen, a specialist in immigration. "Germany has a very complicated history with foreign workers," he says. "Apart from the terrible things that happened with the Nazis, there have been waves of bringing people in and then pushing them out. In the case of the Turks, there were long debates about whether to let them stay or send them back, but most of them ended up staying."

Staying, however, does not necessarily mean assimilation. Today, only half of them are German citizens. Molthagen explains that until 2000, obtaining German citizenship was very difficult. "This was a watershed moment," he says. "Germany accepted being a country of immigrants.

"The Turkish government also made it difficult," he says, because Turks were not allowed to have dual citizenship. "So there are Turkish guest workers who have lived here for 50 years who don't have German citizenship because they say they don't want to give up being Turkish."

There are plenty of shining examples of assimilation, Molthagen points out, but he sees trouble on the horizon. "The connection to the old country has been growing in the last

KAI LOEFFELBEIN/LAIF/REDUX

years, and that can be attributed to Erdogan," he says, referring to Recep Tayyip Erdogan, the strongman president of Turkey.

Over the past few years, Erdogan has made many incendiary statements: calling for Turks in Germany to learn Turkish first, attacking German immigration laws as racist and telling Turks to resist assimilation. He even campaigns in Germany for the substantial bloc of Turkish votes there.

His relationship with Merkel appears to be based more on mutual need than on mutual respect. Last year they negotiated a deal whereby Erdogan would stem the flow of refugees leaving Turkey for Europe in exchange for eliminating visa requirements for Turks and providing his government with over $3 billion to mitigate the cost of housing millions of refugees. But Erdogan periodically threatens to torpedo the deal.

"The Turkish government has always been very involved with the Turkish community here," Molthagen says. "This was never seen as a big problem in Germany until Erdogan. When he changed the law and made it possible for Turks living in Germany to be able to vote in Turkey, Germany became a campaign battleground."

Later that evening I found myself being guided around Berlin by Luis Carlos Kliche. It was almost midnight as we walked through an eerily deserted Checkpoint Charlie, a more appropriate atmosphere than the usual daytime circus of tourists. Luis Carlos studies international relations at the prestigious Freie Universitat Berlin. His father is German and his mother is from Nicaragua. He is equally at home in the languages and cultures of both countries. But he clearly looks Latino, and this, he says, often marks him as an outsider to Germans.

"Look, it's not the case across the board, but the fact is that if you're dark-skinned you're not really considered German," he says. "In a sense, for me it's a bit easier because I do think of myself as partly German, but for immigrants who have no German roots, it's much harder."

Kliche is not sanguine about the prospects that immigrants from the Middle East and Turkey have in becoming assimilated Germans. "Sure, it's possible, but look at what's happening here in Berlin," he says. "Many of these people live in enclaves with their extended families. How are they going to assimilate that way?"

He says the one group that has managed more than others is the Vietnamese. "I think I have more Vietnamese in my classes than people of Turkish descent," he says. In fact, the Vietnamese who came after the fall of Saigon are widely considered an immigrant success story. But those who came from North Vietnam to East Germany, where they were not taught German and largely left to their own devices, have remained much more marginalized after German unification.

The following evening, after a dinner in an Afghan restaurant with Kliche, I walk alone down Karl Marx Strasse in the Neukolln neighborhood, one of the hippest in Berlin. This place has a very different feel from what I'm used to in Germany. Statistically, the neighborhood is supposed to be about half people of foreign extraction – the definition of this is not exactly clear. But at night it seems like the more Germanic-looking people fade away. And when I stop in front of an Arab market to look at the hookahs in the window, I find myself being stared at by three men inside the store.

The store appears to be closed, but probably because I look in wonder at the elaborate hookahs, one of the men comes out to the street to ask if I like them. In short order I am inside; they quickly identify me as an American and begin to load a hookah with intimidatingly dark tobacco. It is as much a dare as an invitation, but many adolescent experiences with bongs delude me into thinking I'll be OK.

Between coughing fits and the laughter of my hosts, I manage to steer the conversation to their experience in Germany. Mahmoud Shadid is the owner of the store. He's 54, Egyptian and he's been in Germany almost 20 years. "I was in Cairo five years ago," he says. "Horrible. I couldn't take it. The dirt. The chaos. I was happy to see my family, but I love Berlin."

Shadid says his business selling hookahs and tobacco is thriving, especially with the arrival of new immigrants from the Middle East. "Even young Germans are trying it," he says proudly. But when I ask him if he feels German after being here so long, he's emphatic: "No. I will never be a German. Maybe my children. They only speak German. Very bad Arabic. But it's hard. Look at us. To Germans, we don't look German."

He points to his friends, a newcomer from Syria and a Turk who was born in Berlin. They continue to ply me with different flavors of tobacco, and as I hover between a nicotine high and nausea, the Syrian (named Nizar), who seems younger than the other two, says, "I would like to come to America. I have family. Iowa. Sidrah Rapids. They are Americans. They like it very much."

SOUTH BERLIN

I drive south of Berlin, where I've agreed to meet Alexander Belmadi outside Tempelhof Airport, a Cold War icon when it served as the hub for the Berlin airlift in 1948. It was converted into a refugee center in 2015 after having been abandoned for years.

"The term of art here in Germany is not assimilation, but integration," he says. Belmadi has worked with refugees for two years now. He's a dual citizen – his father is French and his mother German.

"The concept of integration is a bit of a joke, to tell the truth," he says. "Politicians talk in terms of *ausbildung*, meaning you learn a trade as an apprentice and get a job in a factory. We are very proud of this model, but for most it just doesn't work. Learning this language is very difficult to begin with. On top of that, they're traumatized. Every day they are thinking of the family members they've left behind." He says only a small percentage actually thrive in the system.

Beyond the fact that most refugees have very little education, Belmadi thinks German society poses its own challenges. "Unlike the French, the Germans have no colonial history," he says. "They've never internalized the fact that a German can have something other than white skin and blue eyes. So you can be integrated, but you are integrated as a foreigner."

And in what is quickly becoming a common refrain, he points to the Turkish community. "Most Turks have never been initiated into the German concept of consensus, which is so fundamental," he says. "Erdogan has energized part of the community here, and that, in the eyes of Germans and assimilated Turks, makes them look like foreigners. They are supportive of a dictatorial regime, which here in Germany, considering the Nazi past, is an extremely delicate issue. It's like betraying the new Germany."

So what does it mean to be German? I ask. "It's a difficult question that in the end means very little," he answers. "In France, in the U.S., you can ask that question and get lots of different answers. But here the question creates anxiety, and in the end I don't think there's any answer beyond living in Germany. It's about everyday life, going to your job, having friends." And in another common refrain, after running through the litany of problems Germany faces with its immigrant and refugee community, there's the upbeat coda. "Of course it's going to work," Belmadi says. "There's no other choice. We'll all adapt."

TRUMP'S SHADOW

Near the end of my last visit to Germany, I sat with Konrad Litschko, a young journalist who works for the left-leaning *Die Tageszeitung* newspaper. He covers the right-wing parties including Alternative for Germany (AfD) and Pegida, which is an ultranationalist party founded in 2014 whose less-polished core message is rabidly anti-Muslim and anti-immigrant. AfD goes to great lengths to stress it's different from Pegida, but there has been overlap in membership and discourse.

The right tends to draw more support in areas like Saxony, once part of East Germany, which still suffer from higher unemployment and poverty rates. A poll taken at the end of last year in Saxony showed 25 percent would vote for Alternative for Germany in the next elections. Attacks against immigrants have risen sharply in the past two years, especially in cities, including Dresden and Leipzig. "There are also plenty of places in West Germany where the right has made inroads," Litschko acknowledges, "but the numbers tend to be quite small."

One can't help worrying that this could change. When hundreds of men of largely North African and Arab descent sexually harassed as many as 1,000 women in Cologne's train station on New Year's Eve 2015, the reaction was swift – and not just from the right. "What happened in Cologne was a watershed moment," Litschko says. "All the polling shows a big change in attitude after that. And even though it later came out that some of these men were not refugees and that there are all sorts of sexual harassments done by Germans at Oktoberfest, the debate had begun."

Even Chancellor Merkel, the architect of the open-door policy, has backpedaled a bit,

SEAN GALLUP/GETTY IMAGES

After running through the litany of problems Germany faces with its immigrant and refugee community, there's the upbeat coda. "Of course it's going to work... there's no other choice. We'll all adapt."

vowing to limit the number of refugees this year, hurrying the process of deportation for those who don't qualify and calling for a ban of the burqa. "The full veil is not appropriate here. It should be banned wherever it's legally possible," she said last December.

The burqa-ban proposal is likely no more than posturing for her conservative base, since the German media was unable to find any evidence of women wearing a full veil anywhere in Germany. One does see plenty of drab black abayas, but the face is left uncovered.

Now, to further complicate matters, comes Trump. "Petry was one of the first in Germany to publicly congratulate Trump," Litschko says. "It isn't just about going against immigrants, but also going against the establishment – what she calls the Merkel regime. Now they look at Trump, and they are thinking their moment has come.

"The right is clearly gaining ground," he says. "Still, a large majority of Germans say they support liberal democratic values. So even though there is a shift, I don't see it happening as fast or as profoundly as in the U.S."

Judging from my recent travels through Germany, I'm inclined to agree. But as we've learned, democracy is fickle and unpredictable. Germany, in spite of its past, now serves as a beacon for Western democratic values. Those values were plainly evident in Merkel's open-door refugee policy, even if the policy fell short on the issue of bringing along public opinion. In the end, the question remains unanswered: what does it mean to be German?

ALEC:
Headline is "Where Did All the Men Go?"
Caption for Home page is: "The rise of the unworking"
Main topic: Demographics
Other topics: Human Capital, Job Creation

Where Did All the Men Go?

The Rise of the Unworking

BY NICHOLAS EBERSTADT


DEXTER

While there are a dozen plausible reasons for the shocking result of the 2016 presidential election, the discontent of white men lacking college degrees ranks high on most lists. And no small part of that discontent is linked to their diminishing role in the workplace.

Over the past two generations, America has suffered a quiet catastrophe in the collapse of work for men. In the half-century between 1965 and 2015, work rates (the ratio of employment to population) for the American male spiraled relentlessly downward – a seeming flight from work in which ever-greater numbers of working-age men exited the labor force altogether. America is now home to an army of prime-working-age men, some seven million of them ages 25 to 54, who no longer even look for work. Consider a single fact: in 2015, the work-rate of males aged 25 to 54 was slightly lower than it had been in 1940, when the official unemployment rate was 14.6 percent and the United States was just coming out of a decade of depression in which the search for work was usually futile.

BY THE NUMBERS

To understand what's happened and why, some perspective is valuable. For good or ill, America is living through a period that I would describe as a second gilded age. Somehow, in spite of lackluster growth by historical standards, the 21st-century American economy has managed to produce markedly more wealth for its elite, even as it generated markedly less employment for its workers. Between the third quarter of 2000 and third quarter of 2016, household and nonprofit net worth soared from $44 trillion to just over $90 trillion, while the work rate (for both genders combined) fell by five percentage points – levels last recorded three decades earlier.

That contrast offers insight into a number of overarching features of our time, including rising sentiments of anger and despair – and the increasing attraction of both right- and left-wing populism. It also helps to explain why majorities in public opinion surveys tell pollsters that America is still stuck in the midst of a recession in spite of the reality that the officially recorded unemployment rate (4.7 percent as of January 2017) is close to the record lows enjoyed in 2000.

However problematic America's employment profile may appear to the unaided eye, trends for America's men are yet more dismal. And the cloud is hardly a passing one: Between 1948 and 2015, the work rate for men 20 and older (all postwar employment data are for the civilian noninstitutionalized population) fell from 85.8 percent to 68.2 percent – a drop of almost 18 percentage points. To put it another way: while many economists argue that the economy is currently at or near "full employment," the work rate for men 20 and older was over a fifth lower than it was in 1948.

Of course, this particular measure includes men 65 and older – that is, those of traditional retirement age. But the trend doesn't look very different when the rapidly growing 65-plus population is eliminated from the reckoning. By 2015, nearly 22 percent of the

NICHOLAS EBERSTADT holds the Henry Wendt chair in political economy at the American Enterprise Institute in Washington. This article is adapted from his book, *Men Without Work: America's Invisible Crisis*.

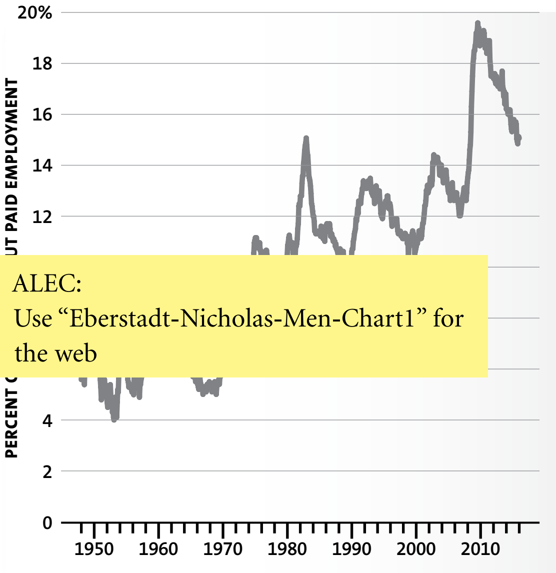
PREVIOUS PAGE: IAN THOMAS JANSEN-LONNQUIST/THE NEW YORK TIMES

ASHLEY GILBERTSON/VII/REDUX

age 20-to-64 group of men was reportedly not engaged in paid work of any kind. This was nearly 12.5 percentage points more than the 1948 level – meaning the fraction of men ages 20-64 not at work was more than twice as high in 2015 as in 1948. As for prime-age men – the 25-54 group, the segment for whom paid employment has always been highest – work rates sank almost 10 percentage points in the same period, from 94.1 percent to 84.3 percent.

Here's another way of thinking about the current work deficit for men. One reasonable benchmark for measuring that gap is the mid-1960s, when U.S. labor markets were apparently functioning at genuinely full employment levels. If age-specific work rates had simply held constant from 1965 to today, another 10.5 million men age 20-to-64 would have had jobs in 2015 – including an additional 6 million in the prime 25-to-54 group.

PERCENTAGE OF CIVILIAN NONINSTITUTIONAL PRIME-AGE MALE POPULATION WITHOUT PAID EMPLOYMENT, 1948–2016



SOURCE: Bureau of Labor Statistics, Current Population Survey

Yes, there is one important respect in which the 10.5 million figure overstates today's work deficit. It does not take into account the steady increase in education and training for adult men over the past five decades. But the magnitude of the relevant adjustment is not especially comforting. Census Bureau data suggest that adult schooling currently takes about a million more working-age men out of paid employment than if 1965-era adult enrollment ratios still prevailed. So the corrected gap for 2015 is "only" 9.5 million male jobs.

OUT OF SIGHT

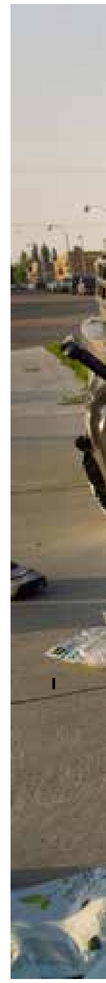
The devastating drop in employment for American men over the past two generations presents us with something of a dog-not-barking question. How can so many millions be absent from payrolls with so little consequent sociopolitical upheaval?

Two big postwar changes in the American labor market suggest the answer. The first was the epochal transformation in the nature of women's work. Before World War II, the exclusive economic activity for the overwhelming majority of American women was unpaid labor at home. Today, the overwhelming majority of women – including those with relatively young children – engage in at least some remunerated employment. And this long upsurge of employment for women has effectively disguised the steady decline in work for men, both by generating new sources of household income and by replacing men who once held jobs.

Second, for complex historical reasons, a caste of men has arisen that finds it socially acceptable and financially possible to scrape by in an employment-free existence. Not only are these men not actively looking for work, but for the past two decades only a small minority of them have reported they are out of the labor force because they cannot find jobs (the classic definition of a "discouraged worker"). Thus, in effect, this flight from work has been possible to ignore because it has ostensibly been voluntary.

Until roughly the outbreak of World War II, the overwhelming majority of nonfarm working-age men in the United States were either working a paid job or looking for one. There was no third way for healthy, able-bodied males. In our America, by contrast, the taxonomy of employment includes a third category: neither working nor seeking work.

The rise of the unworking American man underscores the deeply antiquated and misleading nature of our primary measure of labor-market health: the unemployment rate. By that hoary yardstick, the employment situation for prime-age men in 2015 and early 2016 looks pretty good. But the unemployment rate, which calculates the percentage of



DANNY WILCOX FRAZIER/REDUX

For complex historical reasons, a caste of men has arisen that finds it socially acceptable and financially possible to scrape by in an employment-free existence.

people in the labor force who are without work but seeking jobs, was devised in an age in which mass withdrawal of working-age men from the labor force was inconceivable.

Between 1965 and 2015, the number of prime-age men neither working nor looking for work grew more than three times faster than the number in the workforce. Indeed, the economically inactive have come to eclipse the unemployed as the main category of men without jobs. By 2015, in any given month, there were on average three "unworking" prime-age men for each prime-age man out of work but looking for a job. At no point in the past two decades – not even during the Great Recession – have the unemployed exceeded the economically inactive among American prime-age men.

America's declining male labor-force participation rate is not typical of modern Westernized societies. While there has been some decline in the postwar prime male labor-force participation rate in all of them, the flight from work has been more extreme in America than in almost any other economically advanced democracy. Today, America is

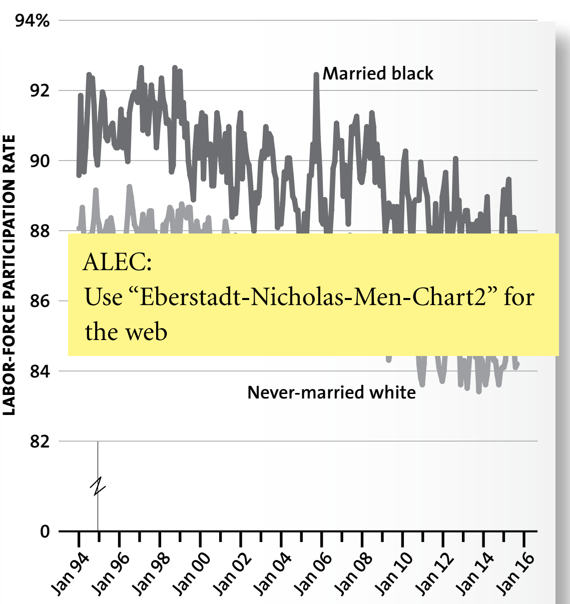
22nd out of 23 in prime-age male labor-force participation, underperformed only by Italy.

DIGGING DOWN

Purely as a matter of arithmetic, the collapse of work among American males is largely due to the rising numbers of men no longer seeking jobs. Between 1965 and 2015, the prime male exodus from the labor market accounted for fully seven-eighths of their total work-rate decline – and unlike withdrawal from the labor force at older ages, a mass withdrawal from the workforce in the prime of life cannot plausibly be attributed to retirement.

Who are these seven million men who have left the workforce in what should be their prime working years? As one might imagine, a pool of seven million is large enough to include all sorts of people. But some groups of prime-age men were more likely to be not in the labor force than others. The overrepresented groups include the American-born (as opposed to immigrants), individuals with less than a high school education, the unmarried, those without children and blacks.

LABOR-FORCE PARTICIPATION RATE FOR MEN AGES 25–54 BY MARITAL STATUS AND RACE



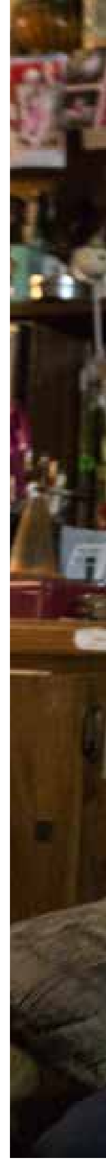
SOURCE: Bureau of Labor Statistics, Current Population Survey

This suggests that broad social forces are at work here. Such a formulation, however, can lead to the conclusion that individual prime-age men have no role in determining their life outcomes. And this is manifestly not the case.

Consider race and ethnicity first. The residual legacy of prejudice and discrimination might seem to explain why prime-age male work rates and workforce participation rates are lower for blacks than whites. But this doesn’t explain why work rates and labor-force participation rates for white men today are lower than they were for black men in 1965, at the end of the Jim Crow era. Nor does it explain why labor participation rates of prime-age married black men are higher than those of never-married white men of those same ages.

Consider education next. Important as the advantages of education plainly are, we can also see how behavior and choice also affect labor-market outcomes for men. For prime-age men with less than a high school degree, labor-force participation rates today are roughly 20 percentage points higher for those who are married than for the never-married. So consequential are the correlates of marriage that workforce participation rates for prime-age men today are essentially indistinguishable for married high school dropouts and never-married college graduates.

Now consider nativity. Regardless of ethnicity, prime-age male immigrants are more likely to be in the workforce than their native-born counterparts. In fact, native-born white men are now less likely to be in the workforce than black men born in other countries.



STEVEN ST. JOHN/THE NEW YORK TIMES

Moreover, foreign-born prime-age male high school dropouts – a disadvantaged group if ever there was one – have labor-force participation rates very close to those of highly advantaged native-born male college graduates, with whom they arguably share very little save their exceedingly low odds of being out of the workforce.

Why are married men and foreign-born men more likely to be in the labor force (and also to find work), all else being equal? A wedding ring does not confer innate social advantage in the competition for jobs; neither does a green card (as opposed to citizenship). Rather, marriage and migration decisions speak tellingly to motivation, aspiration, priorities, values and other intangible characteristics that do so much to explain real-world achievement.

THE ECONOMIST'S PERSPECTIVE

Why have prime-age male labor-force participation rates dropped so steeply over the past two generations? Economists are inclined to approach this question by parsing the problem into subsidiary components: demand-side effects (fewer jobs available), supply-side effects (less willingness to work at a given wage) and institutional effects (barriers to employment for those willing to work).

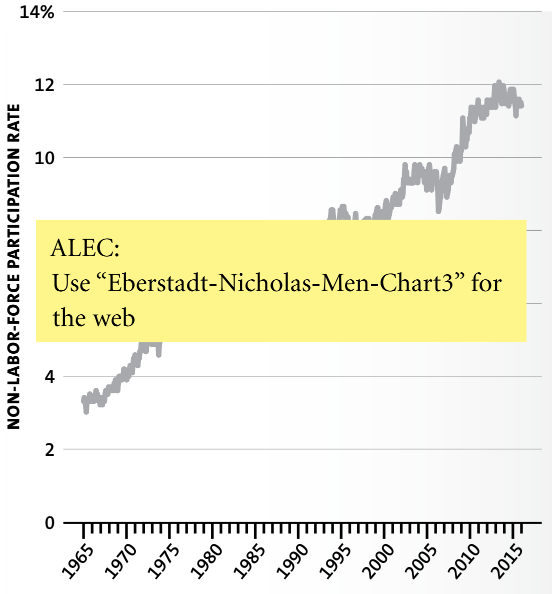
HENNING BODE/LAIF/REDUX

A recent report by the President's Council of Economic Advisers offers a thoughtful presentation of the demand-side explanation, focusing particularly on the evidence for decreasing demand for less-skilled labor in postwar America:

> Economists do not have a singular answer for why demand for lower-skilled and middle-skilled labor is falling. Possible causes include technological advances and globalization, including import competition and offshoring. … Some economists point to "skill-biased technological change:" advances that benefit workers with certain skills more than others. … These forces have, among other things, eliminated large numbers of American manufacturing jobs over a number of decades … leaving many people – mostly men – unable to find new ones.

RATE OF NON-LABOR-FORCE PARTICIPATION, 1965–2016

MALES 25-54 YEARS OF AGE



SOURCE: Bureau of Labor Statistics

Most economists would agree that these structural changes have depressed the demand for labor – especially for less-educated labor – in the postwar era. The subtler question, however, is quantitative: how much of the overall men-without-work problem do these demand-side factors explain?

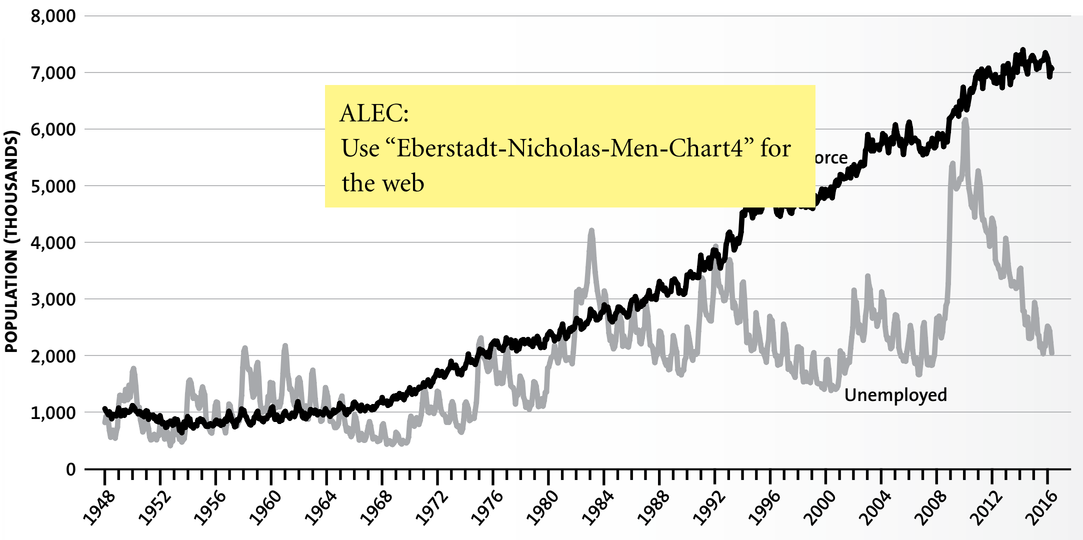
There are reasons to suspect that structural changes may have had less impact than is widely believed. The first is the uncanny linearity of the decline in labor-force participation rates for prime-age American men: The great male flight from work has traced out something like a straight line downward for the past half-century, apparently almost totally uninfluenced by the business cycle or secular changes in the tempo of economic growth. Second, demand-side effects clearly do not affect all lower-skilled men. Today an extraordinary 24 percentage point gap separates foreign-born and native-born prime male labor-force participation rates for prime male high school dropouts.

Then there is the curious question raised by regional disparities in prime male labor-force participation rates. One might expect that regional differences would diminish with time, as labor markets sought equilibrium after demand-side shocks. But state-level disparities in that group have been rising, and steadily so, for the past three and a half decades. Moreover, some of the states with the very highest prime-male inactivity levels happen to be right next door to some of those with the lowest levels: West Virginia (20.3 percent in 2014) borders Maryland (8.7 percent), Maine (14.3 percent) borders New Hampshire (8.8 percent), and so on.

What, then, is the evidence for “supply-side” explanations – changes in preferences and incentives that encourage men to withhold their labor? Even though unworking prime-age men report practically no earned income of their own these days, they are not entirely without means. According to the Census Bureau, households in which a prime-age male was not in the labor force averaged \$37,000 in annual resources in 2014 – just about the same as for homes with working men, and actually more than for homes of unemployed men.

In addition to being supported by their women and by other members of their households, unworking men today are substantially subsidized by Uncle Sam. Indeed, a standard federal government source, the Census Bureau’s Current Population Survey, notoriously underestimates the dimensions and magnitude of such public largesse. A 2015 study by Bruce Meyer and Nicholas Mittag of the University of Chicago, for example, used New York City’s administrative records to check the accuracy of the survey’s information on welfare benefits for low-income

MALES 25–54 UNEMPLOYED VS. NOT IN LABOR FORCE
JANUARY 1948-MAY 2016, SEASONALLY UNADJUSTED



SOURCE: Bureau of Labor Statistics, Current Population Survey

Disability benefits constitute a major source of public support – and an increasingly important source of support – for working-age men not in the labor force.

households. They found that the survey's head count of program beneficiaries missed "over one-third of housing-assistance recipients, 40 percent of food stamp recipients and 60 percent of TANF [temporary assistance for needy families] and general-assistance recipients."

A better source for information on government benefits may be the Census Bureau's Survey for Income and Program Participation. According to this source, as of 2013, over three-fifths of prime-age men not in the labor force lived in homes that relied on at least one means-tested program for income. Some 41 percent of these men lived on food stamps, while just over half reported using Medicaid, a noncash benefit program.

Means-tested benefit dependence for these men appears to have risen substantially over the past generation. Since 1985, the proportion of homes with men not in the labor force that obtained at least one means-tested benefit jumped by nearly 20 percentage points – much more than for homes with prime-age men who were unemployed but looking for work, to say nothing of homes with working men in them.

Disability benefits also constitute a major source of public support – and an increasingly important source of support – for working-age men not in the labor force. Alas, there is considerable uncertainty and even confusion about the true extent of the dependence of such men on disability programs. There is no central authority keeping track

NINA BERMAN/NOOR/REDUX

of America's many disability programs (most notably Social Security Disability Insurance, Supplemental Security Income and veterans' disability) and the many hundreds of billions of dollars every year that they dispense. But the Census Bureau's survey does offer a glimpse.

According to that survey, in 2013 some 57 percent of prime-age unworking men were getting benefits from at least one government-disability program. That share was nearly 20 percentage points higher than in 1985. Roughly a quarter of these same men reportedly received such benefits from two or more programs. Nearly two-thirds of prime-age men in that category live in homes that get at least one disability check. Moreover, there are reasons to believe that the Census Bureau survey's numbers understate the true extent of such dependence.

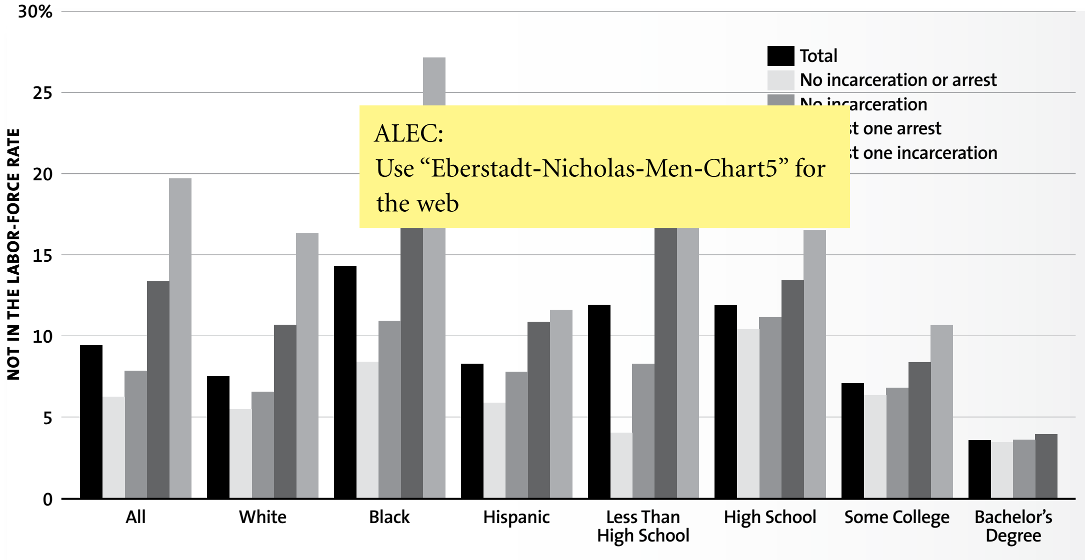
JUSTIN COOK/REDUX

To be clear, prime-age men in America who are not in the labor force do not typically enjoy lavish lifestyles. But their living standards may not be as penurious as some assume, either. And the evidence suggests their living standards have been rising steadily. I do not contend that the greater availability of social-welfare benefits (including disability benefits) has caused the great male flight from work. What is incontestable, though, is that these benefits have in some measure financed it.

Changes in mores and incentives – supply-side effects – are thus clearly part of the dynamic underlying the great male flight from work. And yet, even after taking account of the impact of demand-side and supply-side effects, we are still left with something of a mystery.

America has the rich world's very worst record of prime-age male workforce participation declines, even though many other affluent democracies have weaker growth rates (think of demand-side effects) and more-generous welfare states (supply-side effects). Surely something else must also be at play in this grim drama.

PERCENT OF MEN (30–54) OUT OF THE LABOR FORCE
BY ETHNICITY, EDUCATION AND CRIMINAL JUSTICE SYSTEM HISTORY (2013)



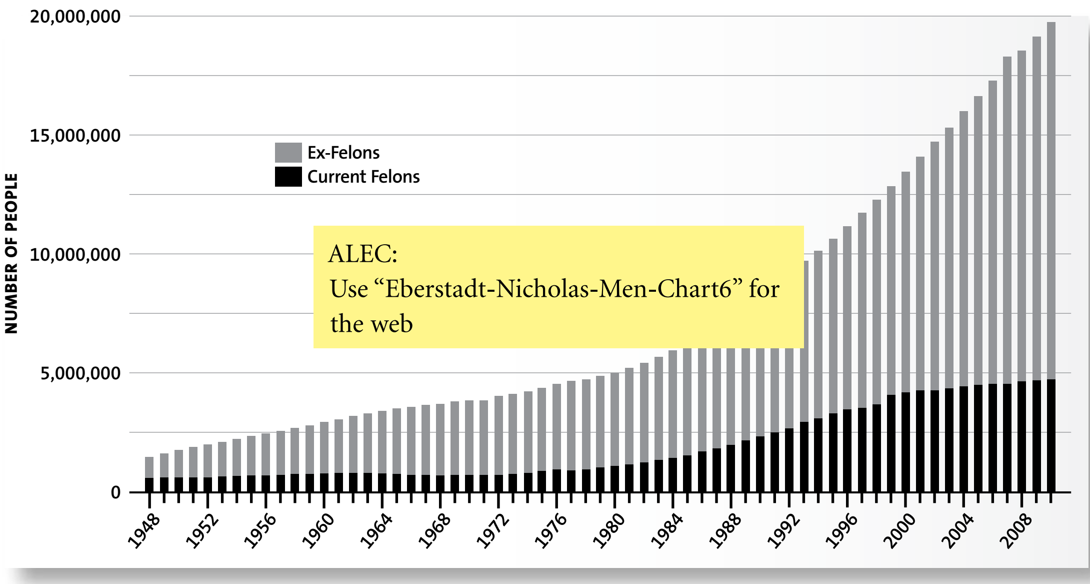
SOURCE: Felony Conviction Rates: Table 4, Percent of Men Out of the Labor Force Using the LFSY79, Price et al., July 2016

That something is what economists wonkily describe as institutional barriers. Start with the fact that the past half century has seen an explosive rise in criminal sentencing and incarceration in America on a scale unlike anything witnessed in other Western societies in modern times. Today, the United States is home to a vast and largely invisible army of felons and ex-prisoners, overwhelmingly men of prime working age. These men are disproportionately high school dropouts, disproportionately native born, and disproportionately black. These ex-convicts fare very poorly in the labor market – and their diminished prospects constitute the key missing piece to the puzzle of understanding the collapse of work for men in modern America.

Few of us today are aware of the staggering size of this group. In a forthcoming study, Sarah Shannon, a sociologist at the University of Georgia, and five colleagues estimate that America’s criminal class (people with a felony conviction or prison time in their background) roughly quadrupled between 1980 and 2010 – from 5 million to nearly 20 million. Given the flow of sentencing since then, we might expect that population to have topped 23 million by now. And since roughly two and a half million people are behind bars today, this means that 20 million released felons and ex-prisoners are living outside institutions. This implies that at least one in eight adult men in the at-large population has been sentenced for a felony. And the ratio for prime-age men could be even higher, given the upsurge of sentencing in recent decades.

In light of these ghastly numbers, the obvious question concerns the employment profiles for men who have served prison time or have been convicted of felonies but not incarcerated. Try as one might, however, it is impossible today to glean such information from official statistics. The federal government simply does not collect data on their

ESTIMATED POPULATION OF FELONS AND EX-FELONS
1948–2010



SOURCE: Shannon et al., The Growth, Scope, and Spatial Distribution of America's Criminal Class, 1948-2010

social or economic condition. This scandalous oversight helps explain why policymakers and researchers have paid so little attention to institutional barriers in America's problem of men without work.

For my own research I reconstructed employment profiles for sentenced men using nongovernment data.

The National Longitudinal Survey of Youth, for example, asks respondents about delinquency, arrest and prison time in its considerable battery of interview questions. And since the survey began in 1977, some of the youths it has tracked are now well into their 50s. Given the arcane particularities of the survey, its employment figures are difficult to harmonize with official Bureau of Labor Statistics data. But the findings from NLS are stark, and absolutely unambiguous, nonetheless.

Regardless of a man's age, ethnicity or educational attainment, he is much more likely to be out of the workforce if he has served time in prison than if he only has an arrest record – and also much more likely to be out of the labor force if he has an arrest record than if he has never been in trouble with the law.

These relationships do not tell us why men who have been through the criminal justice system fare so much more poorly in the job market. There are multiple possible explanations – discrimination and loss of skills lead the list. But the numbers leave no doubt that America's unique trends in criminality and criminalization are a critical part of America's unique contemporary men-without-work problem.

IF NOT NOW

This problem demands attention and action. Reasonable, well-informed people may disagree about the factors that have been responsible for the great male flight from work, or their relative importance. There should be

MATTHEW RYAN WILLIAMS/THE NEW YORK TIMES

no disagreement, however, about its ominous and far-reaching consequences.

Economically, the progressive detachment of ever-larger numbers of adult men from the reality and routines of regular paid labor can only result in slower growth, lower living standards, greater income inequality, higher social-welfare bills and larger budget deficits. Socially, the detachment compromises mobility, trust and cohesion – and much more since the incapacity of grown men to function as breadwinners cannot help but undermine families. Psychologically, it casts those who have been raised to view themselves as the strong gender into the role of dependents – on their wives or girlfriends, on their aging parents, on government handouts.

It is imperative for the health of the nation to bring back these outcasts. But how and where to start? Without precluding other approaches, I would propose that attention be focused on three broad general objectives:

- Revitalizing American business' job-generating capacities.
- Reducing the disincentives to work in existing government-disability programs.
- Facing up to the enormous task of bringing released convicts back into the economy.

I am not suggesting there is a one-and-only best strategy for tackling the problem. Quite the contrary: this should be a let-a-hundred-flowers-bloom moment. The first priority is to bring this invisible crisis out of the shadows and into the glare of public scrutiny – and to create the consensus needed to prevent it from slipping back into the shadows. As long as we allow the crisis to remain invisible, we can expect it to continue.

ALEC:
Headline is “The Rigged Labor Market”
Caption for Home page is: “Adam Smith would be ashamed”
Main topic: Job Creation
Other topics: Human Capital, Public Policy

The Rigged Labor Market

More than two c

a cheerleader for

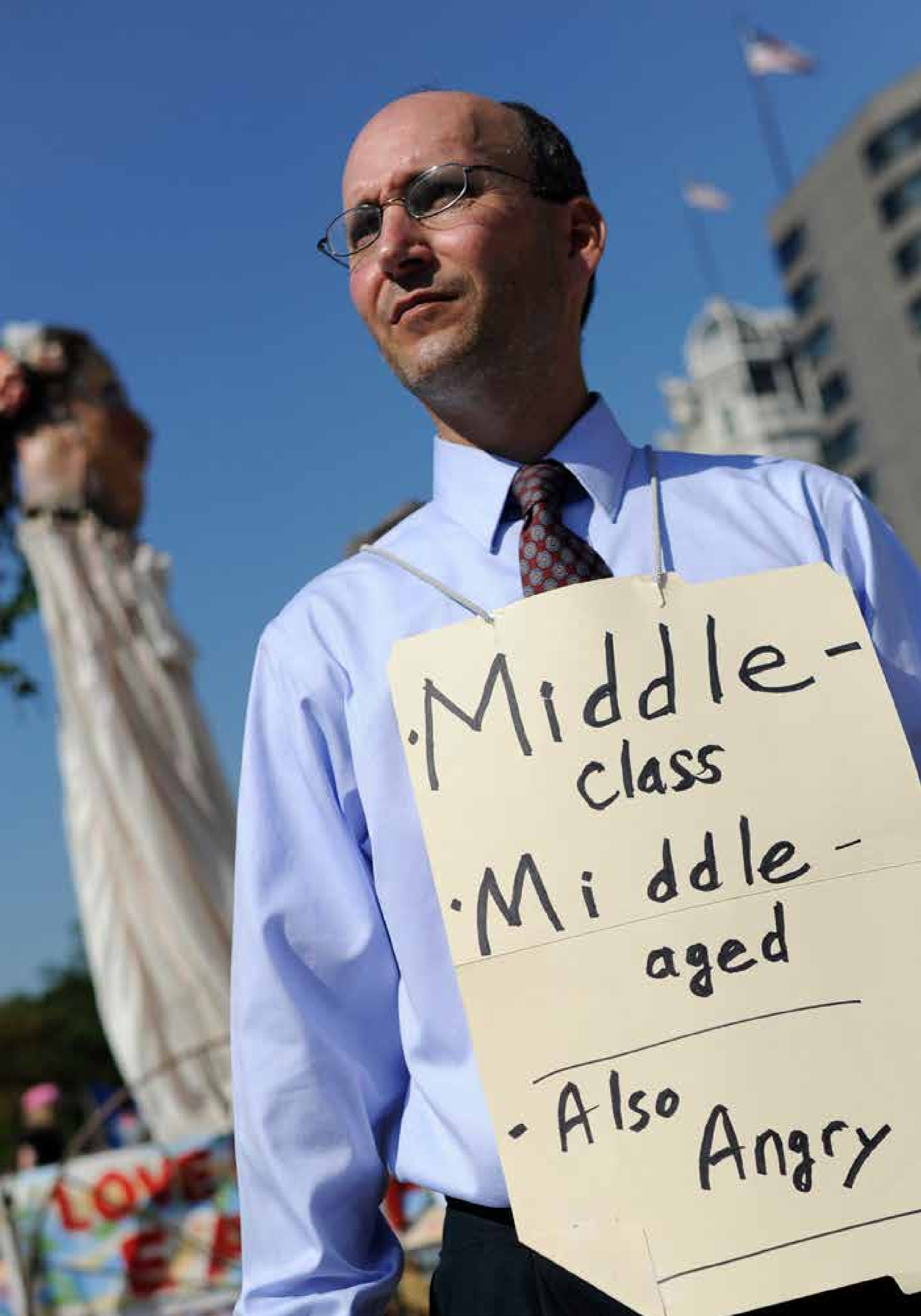
labor was rigged

ulated the labor market to drive workers’ wages below their competitive level. Smith warned that employers “are always and everywhere in a sort of tacit, but constant and uniform combination, not to raise the wages of labor above their actual rate.” And he ridiculed naysayers who denied that employers colluded to press their advantage against workers “as ignorant of the world as of the subject.” He further noted that “we seldom, indeed, hear of this combination, because it is the usual, and one may say, the natural state of things, which nobody ever hears of.”

As in many other areas, Adam Smith’s insights were spot on and prescient. The conspiracy that he warned us about is alive and well in the 21st century, and it still receives little attention from policymakers, economists or the media.

Much research in labor economics over the past quarter century has confirmed Adam Smith’s fear that employers routinely use anticompetitive practices to reduce pay and curtail worker mobility. Research has further expanded our understanding of how “frictions” in the job market, such as imperfect information or costs associated with changing jobs, can give employers anticompetitive advantages even in situations where many employers are vying independently to hire workers. New practices have emerged to facilitate employer collusion, such as noncompete clauses and no-raid pacts, but the basic insights are the same: employers often implicitly, and sometimes explicitly, act to prevent the forces of competition from enabling workers to earn what a competitive market would dictate, and from working where they would prefer to work.

BY ALAN B. KRUEGER



Middle-
class
Middle-
aged
Also
Angry
LOVE

RIGGED LABOR MARKET

This was clear in professional sports before free agency enabled athletes to earn what the market would bear. And it remains the case in many other less glamorous and lower-paying industries. Even professional economists have faced a rigged labor market. The heads of several leading U.S. economics departments used to regularly confer at the Annual Meeting of the American Economic Association to jointly agree upon starting pay and teaching requirements for assistant professors until the Justice Department started nosing around and raising concerns about the legality of the practice.

In one sense, this is encouraging news. It suggests that relatively simple corrective measures would improve the lot of many workers without undermining productivity, growth or job creation. Indeed, countering anticompetitive employer behavior could be a win-win for the economy, raising both pay and employment. But it would take a fundamental shift in perceptions of how labor markets work – one that is a hard sell in an America seemingly disinclined to look closely at how everyday labor practices undermine workers' prospects for moving up the income ladder.

LET'S MAKE A DEAL

Adam Smith could not possibly have anticipated Buzz Lightyear, Nemo or Dory, but the animated movie industry provides concrete evidence of the conspiracy that he warned about. In early 2017, the Walt Disney Company and its subsidiaries Pixar, Lucasfilm and

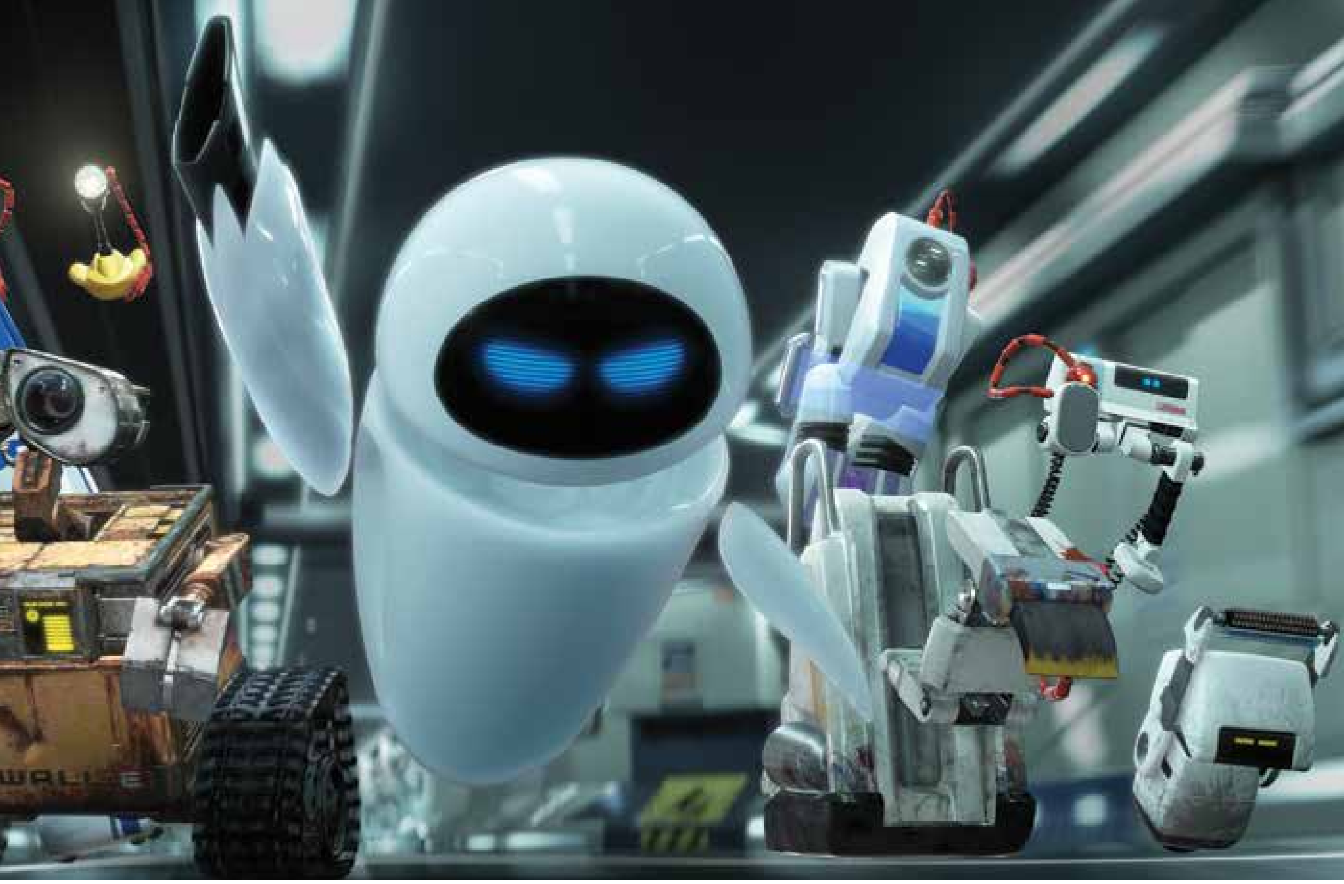
ImageMovers, became the last of the major film companies to reach a settlement in an antitrust suit brought on behalf of movie animators. Along with Sony, Blue Sky and DreamWorks, they agreed to pay $169 million to settle charges that they

> conspired to suppress compensation by agreeing not to solicit each other's employees, to take special procedures when contacted by each other's employees, and to coordinate compensation policies through direct, collusive communications.

The evidence against the film studios, captured in emails, internal documents and sworn testimony, suggests that it was business as usual to conspire to avoid bidding away employees from competitors and to coordinate on pay setting to keep a lid on compensation costs. The conspiracy apparently began with a "gentleman's agreement" between Pixar and Lucasfilm to avoid bidding wars over employees. George Lucas testified that, as a matter of policy, Lucasfilm "would not

PREVIOUS PAGE: XINHUA/EYEVINE/REDUX

ALAN KRUEGER, **a professor of economics at Princeton, served as chairman of President Obama's Council of Economic Advisers and a member of his cabinet from 2011 to 2013. Previously, he was assistant secretary for economic policy and chief economist at the Treasury Department (2009-10) and chief economist at the Department of Labor (1994-95).**



JERRY WATSON/PIXAR STUDIOS/CAMERA JERRY WATSON/PIXAR PRESS/REDUX

Walt Disney Company and its subsidiaries Pixar, Lucasfilm and ImageMovers agreed to pay $100 million to settle charges that they conspired to suppress compensation. The antitrust action had its roots in a Department of Justice investigation of anti-poaching practices used by the tech companies.

actively go out and recruit from other companies." Emails from Lucasfilm human resources personnel indicate that the company even withdrew job offers to Pixar employees whom Pixar deemed "essential."

For its part, Pixar refused to be drawn into bidding wars with its competitor. In an internal document, Pixar stated it would "never counter if the candidate comes back to us with a better offer from Lucasfilm."

The collusion encompassed other major filmmakers as well. An email from a Pixar executive to Steve Jobs, for example, noted that Pixar had an "agreement with DreamWork[s] to not poach their people." And a 2006 list of Lucasfilm's "gentleman's agreements" stated that Lucasfilm would not "recruit actively or passively from DreamWorks … for any positions." Emails also documented that Pixar, Disney, Lucasfilm, Sony and Blue Sky had gentleman's agreements to not recruit each other's employees.

The court ruling that certified the animation workers' class action suit against the film companies concluded: "In addition to the documentary evidence that defendants agreed not to recruit from each other, the documentary evidence supports plaintiffs' allegations that defendants colluded on compensation policies through industry surveys including the Croner Survey, annual closed-door in-person meetings, and emails." Lucasfilm's president, Jim Morris, once invited Pixar's president, Ed Catmull, to participate in a salary survey because he knew Catmull was "adamant about keeping a lid on rising labor costs." Not unlike the economics department chairs, the film company officials often met during industry conferences over meals to discuss compensation issues. At one such "intimate dinner" in 2006, human resources officials from DreamWorks, Disney, Pixar, Blue Sky, Sony and Lucasfilm collectively agreed on average salary increases. Human resources officials also routinely shared their employees' salary ranges with their counterparts at other companies.

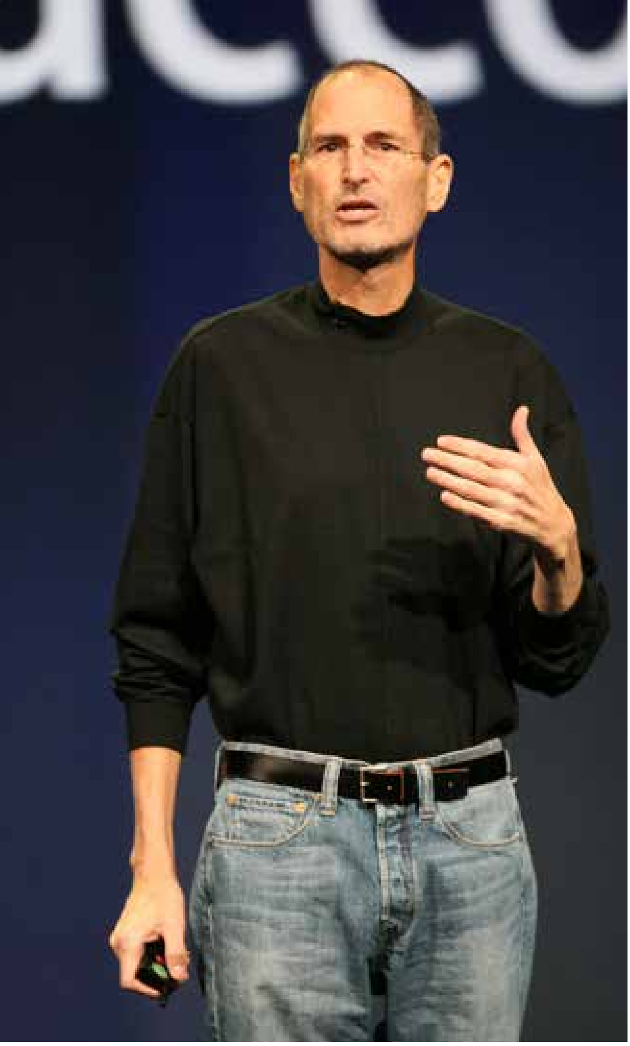
The antitrust action on behalf of the film animators had its roots in a well-publicized Department of Justice investigation of anti-poaching practices used by the tech companies Adobe, Apple, Google, Intel, Intuit and Pixar. That investigation revealed some colorful evidence. For example, after Google's co-founder Sergey Brin tried to hire a programmer from Apple's browser team, Steve Jobs wrote in an email, "If you hire a single one of these people, that means war." When Intel's chief executive, Paul Otellini, was asked by a recruiter about the no-raiding agreement his company had with Google, he responded in words that would ring familiar to Adam Smith: "We have nothing signed. We have a handshake 'no recruit' between Eric [Schmidt of Google] and myself. I would not like this broadly known." The Justice Department complaint was quickly settled in 2010, with the tech companies agreeing to avoid "pressuring any person in any way to refrain from soliciting, cold calling, recruiting or otherwise competing for employees of the other person."

Subsequently, a separate class-action civil suit was brought on behalf of more than 64,000 software engineers and other employees of Adobe, Apple, Google, Intel, Intuit, Pixar and Lucasfilm. The evidence that the tech companies colluded to restrict labor market competition was overwhelming. Before going to trial, the various parties settled. In an unusual move, Lucy Koh, the judge hearing the case, ruled that the initial cash settlement was inadequate. The lawsuits were eventually settled for a total of around half a billion dollars in 2015.

After Google's co-founder Sergey Brin tried to hire a programmer from Apple's browser team, Steve Jobs wrote in an email, "If you hire a single one of these people, that means war."

High-tech employees are not the only ones to have won civil suits alleging anticompetitive conduct by employers in recent years. Several suits have been successfully brought on behalf of nurses against hospitals, for example. On Sept. 16, 2015, the Detroit Medical Center became the last of eight major Michigan hospital systems to reach a settlement in a suit alleging that the hospitals colluded to reduce their pay. The hospitals apparently endeavored to share information about nurses' salaries and pay increases. With pay pushed below competitive levels, the hospitals often turned to temporary staffing firms to hire workers (at salaries above those of existing staff) and made do with vacancies.

Similar cases are in various stages of resolution in Albany, Chicago, Memphis, San Antonio and Arizona.



JIM WILSON/THE NEW YORK TIMES/REDUX

YOU'RE MINE FOR A LONG TIME

Another tactic that employers frequently use to tilt the balance of bargaining power in their favor and restrict competition in the labor market is to require employees to sign noncompete agreements that prevent them from working for rivals for an extended period. Note at the start that mutually-agreed-upon noncompete agreements can sometimes be justified as a means to increase labor productivity. They may give employers incentives to share trade secrets with employees, secure in the knowledge that they won't decamp for a competitor. And noncompetes may give employers and employees incentives to invest in expensive firm-specific training. In both these situations, workers could presumably negotiate for higher compensation in exchange for signing a noncompete agreement.

However, for a vast majority of employees whose work does not entrust them with trade secrets or provide much training, such agreements undoubtedly restrict worker mobility, reduce labor market competition, and suppress pay and productivity by preventing workers from moving to jobs that offer better compensation and working conditions. Nonetheless, according to survey research by Evan Starr of the University of Maryland and J.J. Prescott and Norman Bishara of the University of Michigan, 18 percent of American workers are currently constrained by noncompete clauses. Moreover, nearly 40 percent have signed noncompete agreements at some point in their careers. These figures greatly exceed any plausible estimate of the share of workers with access to trade secrets that could justify noncompete agreements. And the fact that a 2016 Treasury Department report found that the age-earnings profile is steeper for workers in states that do not enforce noncompete agreements than in states that vigorously enforce them strongly suggests that noncompete agreements do not lead to greater job training; instead, they suppress wage growth.

Although noncompete agreements are more common in higher paying jobs, there are plenty of instances in which low-paid service workers are caught in the net. Amazon, for example, requires its warehouse workers, including seasonal hires, to sign an agreement that seems to cover everything but the kitchen sink:

> During employment and for 18 months after the separation date, employee will not … engage in or support the development, manufacture, marketing or sale of any product or service that competes or is intended to compete with any product or service sold, offered or otherwise provided by Amazon.

Noncompete agreements have even become common in the fast food industry. For

example, the sandwich chain Jimmy John's, with 2,000 restaurants, used a noncompete clause that prohibited its employees from working at any other restaurant that sells "submarine, hero-type, deli-style, pita and/or wrapped or rolled sandwiches" within two miles of a Jimmy John's shop while they were employed at a Jimmy John's and for up to three years afterward. The company agreed to drop this practice in New York and Illinois last year after being challenged by the attorneys general in those states.

While Jimmy John's prohibited its employees from working for competitors, McDonald's came at the issue from the other side. The company prohibits its own franchisees from hiring workers away from other McDonald's restaurants; nor can they hire workers who left another McDonald's within six months. With approximately 14,000 McDonald's restaurants employing 420,000 workers across the United States, this restrictive hiring covenant could significantly curtail the freedom of McDonald's workers to seek better pay and working conditions.

HOW LABOR MARKETS WORK IN PRACTICE

In the idealized version of a perfectly competitive labor market, many employers freely compete to hire workers from a large pool. Thus, neither employers nor workers have "market power," meaning the ability to dictate terms of employment that differ meaningfully from the terms offered (or received) by others to workers with comparable skills. In this world, employees can freely (and costlessly) change jobs when better opportunities arise. For their part, employers are able to seamlessly fill job vacancies by simply offering the going wage rate. This wage is determined by the market – by the intersection of the supply and demand curve for labor; nobody has discretion to set pay. Thus, in econ jargon, the supply curve to any firm is "infinitely elastic," implying that if it paid just a

DAVID GOLDMAN/ASSOCIATED PRESS

penny below the going wage it would lose its entire workforce, and if offered just a penny more it would be inundated with able job applicants. An individual employer in a competitive labor market is not subject to the usual law of supply, as there is no upward-sloping supply curve to the firm: paying the going wage attracts all the workers the firm demands.

The opposite of a competitive labor market is one with a single employer. That employer, called a monopsonist, is in a peculiar position because she is subject to the law of supply in the way that an entire industry is in a competitive market. If she wants to hire an extra worker, she must pay a somewhat higher wage since the supply curve she faces is sloped upward. And, as a practical matter, she will need to pay that higher wage to the rest of her workers, too. Thus a monopsonist with, say, 100 employees who finds it necessary to pay an extra dime an hour to hire one more worker, must shell out a total of $10 an hour (100 times 10 cents) more to the existing workforce as part of the price of hiring that additional worker.

Note the critical difference: an employer in a perfectly competitive market, who is one among many, can always hire more workers at the currently competitive wage. So, for this employer, the added cost of one more worker is exactly what she pays that worker. A monopsonist's marginal cost of hiring a worker, however, is higher – perhaps much higher – than the wage paid to that additional worker.

Thus, paradoxically, while a monopsonist is likely to pay less, on average, for labor, than an employer in a competitive market, the monopsonist's cost of labor at the margin is likely to be higher. So, in aiming to maximize profits, a monopsonist will hire less labor and make do with vacancies. And an economy full of monopsonists will be less productive because employers will fail to hire workers who could contribute more value to output than they received in wages.

Jimmy John's used a noncompete clause that prohibited its employees from working at any other restaurant that sells "submarine, hero-type, deli-style, pita, and/or wrapped or rolled sandwiches" within two miles of a Jimmy John's shop while they were employed at a Jimmy John's and for up to three years thereafter.

If the government forces a monopsonist to increase the wage that it pays – by, say, imposing a minimum wage that is modestly above the wage it currently pays – the monopsonist's marginal cost of labor will fall. And this cost at the margin may become low enough to give the monopsonist an incentive to hire more workers. In other words, without a minimum wage the monopsonist operates with vacancies, unwilling to raise the wage it offers to hire additional workers because it would have to pay that higher wage to existing workers as well. However, with a binding minimum wage – that is, a minimum wage above the rate the monopolist was already paying – a monopsonist can fill its vacancies without worrying about having to increase everybody else's wages, because that was already required by the minimum wage. A monopsonist would not be happy with this situation because the minimum wage would cut its profits. But once there is a minimum wage, the firm would find it possible and in its interest to fill its vacancies, provided the minimum wage wasn't set too high.

The canonical example of monopsony is a one-company town – say, a remote coal mining town. While few labor markets are characterized by pure monopsony today, if employers collude to suppress competition – either by restricting labor mobility or conspiring to fix pay – they jointly exercise monopsony power. This should be evident because employers are exercising discretion to set pay, and in a perfectly competitive labor market, employers have no discretion whatsoever to set pay.

Although it remains unclear how pervasive or effective employer collusion is in restricting competition, recent economic analysis suggests that employers often have monopsony-like power over workers even when there are many employers who operate independently. In part, that's because employers have some discretion over what they pay because of labor market frictions, such as job search costs.

For example, in the "wage-posting job search" model pioneered by the economists Kenneth Burdett at Penn and the late Dale Mortensen, and expounded on in Alan Manning's book *Monopsony in Motion*, employers consider the tradeoff between their position on the wage ladder and their employee turnover rate. Employers can choose a low-wage strategy and make do with high turnover and chronic vacancies, or a high-wage strategy with low turnover and few vacancies. Requiring employers who choose the low road to increase their pay would raise total employment by making jobs more attractive and reducing turnover.

In another model of the labor market developed by Mortensen, Chris Pissarides of the London School of Economics and Chris Flinn of NYU, firms and workers bargain over the value that each unique worker-firm match creates. Factors that determine their relative bargaining power, such as the ability of workers to take other job opportunities, influence where the bargain ends up.

Yet other models recognize that, even absent search frictions and idiosyncratic value of worker-firm matches, individual workers value nonwage features of jobs differently. For example, some workers may live very near a McDonald's where they work. Those who live close by would presumably be willing to work for a lower wage at that outlet than those who live far away and must spend time and money on commuting.

It turns out that this very minor and realistic tweak coverts a perfectly competitive labor market to one in which employers have monopsony-like power because firms no longer face a perfectly elastic labor supply curve. If a firm were to cut its wage in this situation,

Smart interventions to redress the imbalance between companies and workers, such as a prudently set minimum wage, or vigorous enforcement of antitrust restrictions on anticompetitive employer behavior, could result in more employment as well as higher pay.

REUTERS/BRENDAN MCDERMID

it would find that some workers would leave (namely, those with a long commute), while others would stay because it is more convenient working at this restaurant than another one. To recruit new workers, every firm would have to pay more than the going wage (to attract workers who live farther away), just as in the case of a single monopsonist. And, as in the case of a monopsony, a minimum wage could lead to higher employment. The takeaway: monopsony-like incentives can intrude on what might otherwise look like a competitive labor market, even when there are many employers.

The details of these models are less important than the general result. A perfectly competitive labor market operates on a knife edge, on which employers have no choice but to pay the going market-determined wage. If they collude to restrict competition and suppress pay, as Adam Smith predicted, or if very common features of the labor market give them discretion over what they pay, they will have incentives to pay less and hire fewer workers. Smart interventions to redress the imbalance between companies and workers, such as a prudently set minimum wage or vigorous enforcement of antitrust restrictions on anticompetitive employer behavior or steps to enhance employee bargaining power, can result in more employment as well as higher pay.

The reality that many, if not most, markets for labor have some of the characteristics of monopsony helps explain a persistent puzzle in labor economics: studies have *not* found strong or even consistent evidence that a higher minimum wage reduces employment, as would be expected to be the case in a perfectly competitive labor market. Indeed, the most comprehensive summary of the recent literature, by Dale Belman of Michigan State

LIBRADO ROMERO/THE NEW YORK TIMES

and Paul Wolfson of Dartmouth, finds that the average study shows essentially no effect of minimum wage increases on employment. Although some companies may respond to a higher minimum wage by reducing employment, this is apparently offset by others who increase employment – as would be expected if some firms have monopsony-like power.

Other evidence at the national level suggests monopsony-like power is restricting pay increases. For example, job openings and posted vacancies have steadily risen in recent years, but hiring has not kept pace. This pattern is sometimes cited as evidence of an economy-wide shortage of skilled workers. Yet, in a competitive labor market, one would expect the phenomenon to be fleeting: employers would bid up wages for skilled workers until vacancies were filled or firms were discouraged from posting vacancies because of the higher competitive wage. Consider, too, that contrary to what one might expect in the face of skill shortages, wages have not grown faster in sectors with rising job openings. This suggests that companies are resisting raising wages as a means to attract more workers – as one would expect in an imperfectly competitive market.

LABOR ECONOMICS 2.0

An important first step in rethinking how labor markets work – and how they could be made to work more efficiently and fairly – is to change the default assumption from the perfectly competitive model we all learned in Econ 101 to one in which employers have some discretion to set pay. This discretion can come about because, as Adam Smith predicted, it is the "natural state of things" for employers to collude, or because of frictions in the job market. We can begin to change the default by changing how we teach economics. Introductory economics textbooks rarely discuss the role of monopsony or collusion in the labor market, although market power is standard fare when it comes to product markets.

While it is difficult to determine at this stage if the antitrust cases brought on behalf of animators, software engineers and nurses indicate widespread employer collusion, the fact that the behavior spans diverse industries and employee skills suggests that collusion may be common. At a minimum, the accumulation of cases suggests that more resources should be devoted to enforcing the antitrust laws when it comes to employers' HR practices.

Toward the end of Obama administration, the Department of Justice and the Federal Trade Commission issued new guidelines for human resources professionals to help identify and report wage fixing and hiring collusion among employers, and created a hotline to report instances of collusive behavior. Moreover, for the first time, the Justice Department threatened to bring criminal (as opposed to civil) cases against individuals and their companies for entering into no-poaching and wage-fixing agreements with competitors. The Obama administration also called on the states to adopt a set of best practices to ensure that noncompete agreements are narrowly targeted and appropriately used.

With the change in presidential administrations, though, the fate of these initiatives is uncertain. While running for president, Donald Trump was fond of declaring, "We will never be able to fix a rigged system by counting on the same people who rigged it in the first place." He used this line to rail against his opponent, the political system, big donors, bureaucrats and big businesses. Although the fact of his election suggests the political system is not rigged in quite the way he claimed, he undeniably tapped into a significant vein of discontent – and, to mix metaphors, a large grain of truth – in arguing that the economy is "rigged against you, the American people."

If he is serious about addressing this problem, there would be no better place to start than by unrigging the labor market by (a) raising the federal minimum wage, which has remained at $7.25 an hour since 2009 and which Mr. Trump pledged to raise to $10 an hour during the campaign; (b) reining in the excessive use of noncompete clauses; (c) vigorously enforcing antitrust laws to prohibit employer anticompetitive practices; and (d) increasing worker bargaining power.

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If President Trump does not try to reverse the ways in which the labor market is rigged against American workers, there is an alternative: the states could step up. Many have already begun to raise their own minimum wages and to prohibit the use of noncompete agreements for low-wage workers, and their attorneys general have been on the vanguard at challenging excessive use of noncompete clauses. The states could also pursue means to improve worker bargaining power and pass tougher laws to penalize employer collusive behavior that restricts worker mobility and suppresses pay.

After all, workers deserve a break too.

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Main topic: Pensions
Other topics: Public Policy, Finance, Labor

Public Pension Plans

The $5 Trillion Misunderstanding

BY ED BARTHOLOMEW

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According to the 2013 annual report for Detroit's general retirement system, the city's pension plan "is stable and secure and expects to meet all future retirement obligations to its members."

Wait. Isn't Detroit bankrupt?! Well, I fudged here just a bit. The annual report quoted preceded the city's bankruptcy by some months. In fact, though promised pension payments were cut, the retirees didn't do too badly. The bankruptcy judge blessed a settlement (at the expense of other creditors) that preserves the lion's share of their benefits. At least for now.

But the mess in Detroit, alas, is only the be-

PREVIOUS PAGE: CARLO GIAMBARRESI/THEISPOT

ginning of a great unraveling of retirement plans for state and local employees in much of the United States. And even relatively happy endings can hardly be taken for granted.

The first question that occurs is who is going to be stuck with the bill. Taxpayers? Pensioners? Residents who will have to make do with lower-quality public services? Going forward, there's also the question of how the process of funding promised benefits should be changed so the funds are sure to deliver. The answer requires a dip into financial theory. But don't let the minor technical hurdles prevent you from understanding a pretty straightforward idea.

JIM WEST/REPORT DIGITAL-REA/REDUX

FIRST, SOME FACTS

Not many of us work for employers who still offer "defined benefit" pension plans, which promise monthly income for life in retirement. In the private sector, such plans have largely been replaced by defined contribution plans – typically 401(k) plans that are less costly to employers and shift most of the risk of saving enough for retirement to employees. But if you're a state or local government employee, you probably still have a defined benefit plan. What's more, the plan may well have been a big factor in convincing you to work for the government because government jobs often make up mediocre pay with generous benefits.

That puts future retirees in the uncomfortable position of depending on contractual rights that may be contingent on courts willing to enforce them – a position made more uncomfortable by the fact that millions of them don't have Social Security as a backstop. This, for example, is the case for the failing Dallas police and fire pension system, which actively resisted attempts to include pensioners in the Social Security system.

Consider, too, that, unlike private pension benefits, state and local pension benefits are not insured by the Pension Benefit Guarantee Corporation, which was set up by Congress in 1974 to insure private pension funds. This exclusion was based partly on a Constitutional objection. But it was also assumed that state and local taxing power would be sufficient to ensure that all promises would be kept. Now, in 2017, that assumption doesn't seem quite so solid.

Making Sausage

Suppose you participate in a defined benefit plan offered by your employer. During your working years, you earn, in addition to wages, the right to an annuity when you retire – a monthly check for life. For example, suppose your employer's plan promises a monthly pension equal to 2 percent of final pay for every year worked. So, if you have worked for 40 years, your pension will equal 80 percent of final pay.

But what if your employer doesn't have the money when the time comes? To mitigate that risk, pension plans are typically prefunded. During your working years, funds are set aside and invested, so there will be enough to pay the promised pension.

How much, then, does your employer need to contribute each year to fund the plan and secure the promise? In deciding that, professional pension actuaries make several assumptions – most critically on how much the plan will earn on its investments and on how long participants will live.

If the actuary knew precisely how much each participant would receive annually in retirement and for how long, as well as the return on the pension plan's investments, the math would be straightforward. But since this information is not known, it must be estimated. And this is where risk creeps in on little cat feet.

The actuary's calculation is based on expected values, where "expected" is the estimated statistical mean for a distribution of possible outcomes. If there's an equal chance that the realized outcome for each assumption will fall

WHEN THE UNTHINKABLE MUST BE THOUGHT ABOUT

Detroit pensioners learned the hard way that, despite soothing messages repeated over and over in the annual reports, a guaranteed pension annuity is only as good as the guarantor. While outright defaults have been rare, they may or may not be so rare going forward. It depends on whom you ask.

Keith Brainard, the research director of the National Association of State Retirement Administrators, notes that unfunded pension liabilities vary widely among plans but believes that "for the vast majority of states, cities and plans," these liabilities are manageable. He attributes the cases of the largest unfunded liabilities, like those in New Jersey, to employers paying less than their actuaries calculate they should – and, presumably, hoping for a wizard investment adviser to save them.

Financial economists, as opposed to the professional actuaries who are paid to tell pension funds what they need to contribute, would agree that is a big problem and a distinguishing characteristic of the worst-funded cases. But they do not agree with Brainard's assessment that there's no systemic underfunding problem with the "vast majority" of public pension plans.

Joshua Rauh, professor of finance at Stanford University, notes in a recent research report that public pension funds still commonly estimate that they'll earn returns on investments of 7.5 to 8 percent annually. Those numbers, based on past earnings on pension portfolios, are probably unrealistic

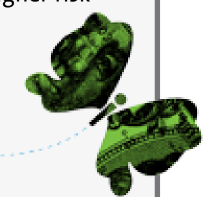
ED BARTHOLOMEW, an independent pension consultant, is the former chief financial officer of the Inter-American Development Bank.

on either side of what's expected, then there will be a one-in-two chance that the calculated funding will be less than what's required to pay the promise. Maybe a little less, maybe a lot less, depending on how much uncertainty there is around each assumption.

Now, while any individual's life expectancy is highly uncertain, the average life expectancy for a group becomes increasingly less uncertain as its size grows. And so, defined benefit plans for large companies that have thousands of participants are effective vehicles for diversifying this type of risk.

Other risks, however, are linked to the discretionary behavior of the plan managers – for example, investment risk. Pension plans could hold low-risk bonds with cash flow matched closely to the profile of the benefit that will be owed. And indeed, insurance companies that sell fixed annuities, which function very much like defined benefit pensions, follow an investment strategy much like this.

The only reason pensions – especially public pensions – deviate from this approach is that it lets their actuaries assume a higher investment return, thereby reducing funding requirements. But this approach comes at a cost: a higher risk of falling short, perhaps by gigantic sums. A trillion here, a trillion there...



going forward. But, like virtually all financial economists who have studied the issue, he has a more fundamental beef with the actuaries' approach. He argues that "this practice obscures the true extent of public-sector liabilities" because it treats an uncertain expected return as though it were a sure thing.

Under rules set by the Government Accounting Standards Board, pension liabilities are valued by discounting promised benefits at the expected rate of return on plan assets. Public pension actuaries employ a similar approach for estimating plan cost and funding requirements. Under this standard, if taking more investment risk allows a pension plan to expect a higher return on those investments, employer contributions can be smaller. The same goes for the value of accrued liabilities – what's owed for benefits earned, but not yet paid.

It's not hard to understand why this approach is popular. Investing in low-yielding but ultra-safe government bonds, which could absolutely ensure the payouts on guaranteed pensions, would vastly increase the cost of plans to employers and, arguably, make pension plans unaffordable.

But this way of justifying business-as-usual rubs financial economists the wrong way because it implicitly treats investment risk as costless. A universal principal of financial valuation is that systematic risk – what's

MICHAEL AUSTIN/THEISPOT

left after diversifying as much as possible – has a cost because risk-averse investors would not otherwise be willing to bear it. Treating the risk premium as earned before the risk has been borne is fundamentally flawed. But that's what the official accounting rules permit.

So why should you care about this in-the-weeds technical difference over the cost of risk and what that implies for the right way to measure pension costs? Because what you don't know can hurt you – whether you're a taxpayer who may be asked to pay more later, a municipal bond investor who may discover she's last in line trying to collect behind a large hidden debt or a pension plan participant who may be at risk for what bankruptcy specialists euphemistically call a haircut.

For fiscal 2014, the total unfunded pension liability for U.S. state and local pensions, reported under the official Government Accounting Standards Board accounting rule, was $1.2 trillion. This $1.2 trillion gap is the difference between the board-estimated liability of $4.8 trillion and plan assets of $3.6 trillion. That means public plans have only 75 percent of the assets needed to cover future obligations, leaving a 25 percent gap to be covered by future taxpayers. And that 25 percent estimate assumes the pension funds will earn the high returns hoped for on a risky investment portfolio – returns of 7.6 percent on average into the distant future.

Financial economists, however, say the underfunding problem is much worse. Rauh, using a much lower interest rate to discount liabilities, put the total fiscal 2014 gap at $3.4 trillion, nearly three times the $1.2 trillion reported under Government Accounting Standards Board rules. If this larger estimate is the true funding gap, state and local plans are barely 50 percent funded. Moreover, adjusting for weak investment performance along with even lower interest rates on riskless investments in the two years since Rauh made his estimate, financial economists guesstimate that the fiscal gap in 2016 is $5 trillion to $6 trillion. That implies the plans have only 40 percent of what they need to meet their obligations.

The main cause for this large difference is, as noted above, the discount rate, which determines the present value of a dollar owed in the future. Higher discount rates make that future dollar owed less costly, and lower discount rates more costly. According to financial economics, the appropriate discount rate for a future cash flow is the rate on a default-free bond (like a U.S. Treasury) due at the same point in time, plus a spread for any risk of nonpayment. Returns expected on assets used to fund the liability simply aren't relevant for the purpose of valuing the liability.

So, if a pension promise is thought to be free of the risk of default, a financial economist would discount it at a default-free rate. And this is what Rauh did.

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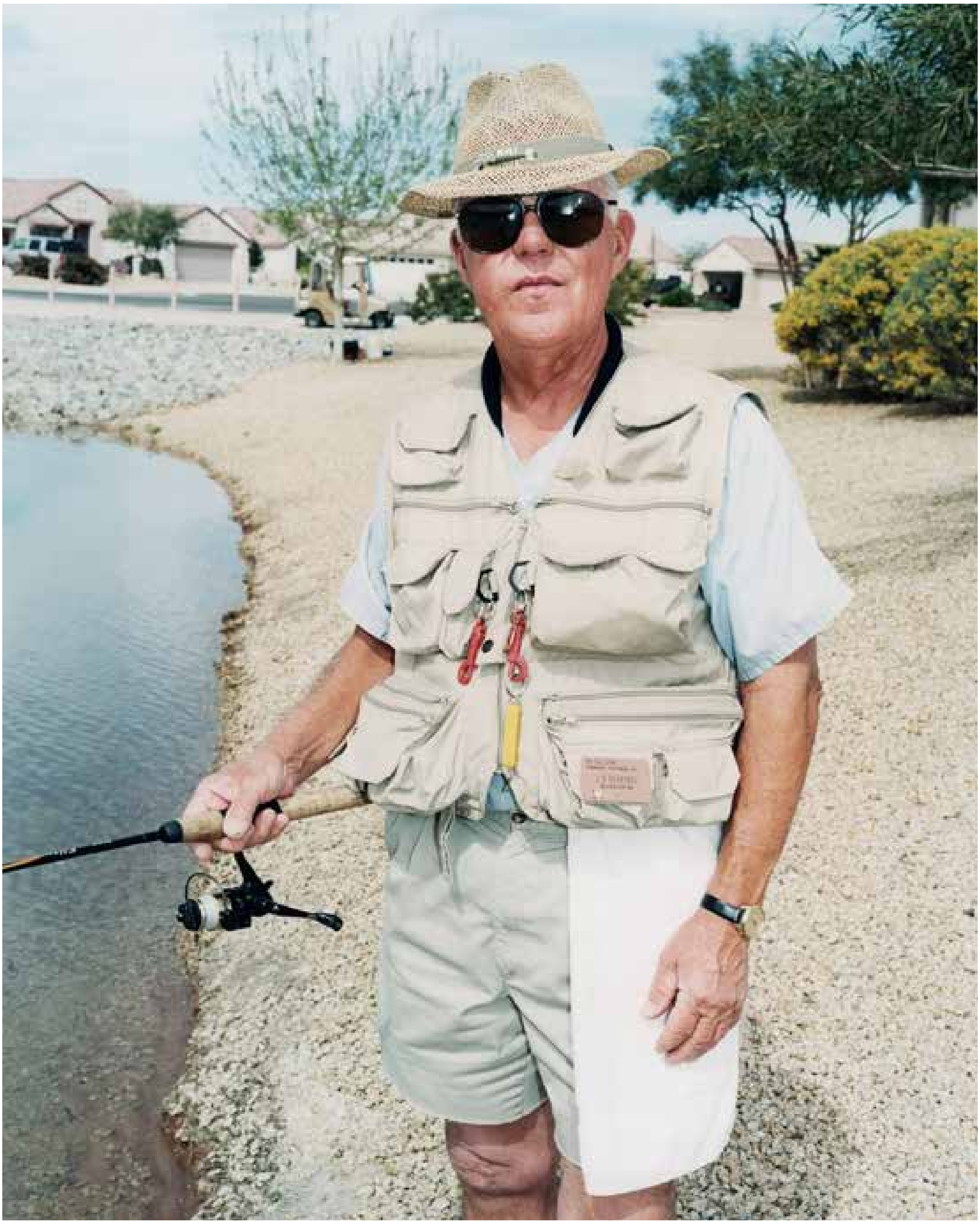

LAIF/REDUX

But wait, you say. We just looked at the failing pension plans in Detroit and Dallas. If benefits are at risk, they're not default-free. Right, but note that's not what Keith Brainard and others advocating for expected-return discounting are basing their argument on. To put it another way, saying that pension debts are smaller because they might not be paid should give no one comfort.

Advocates for the Government Accounting Standards Board's approach (a group that includes most public-pension actuaries) think they are answering a different question. They aren't asking what the market value of the liability is – something they consider mostly irrelevant – but how much needs to be set aside today to pay the promise when due. And if they can reasonably expect a higher return by taking more risk, why can't they assume that's what the plan will get?

Resolving the discount rate debate hinges, in the minds of many, on whether risk stays risky in the long run. If investment risk vanishes – or at least significantly diminishes – over the very long time horizons in which pensions operate, advocates for the standards board's approach claim that allows using the expected return on risky assets to discount liabilities, which would remain secure.

IN THE LONG RUN

If we think of risk only as the bumpiness of the ride, not as uncertainty about where the ride will end, then the so-called equity premium – the extra return expected for stocks – is merely compensation for fortitude and patience. And if earning an equity premium is guaranteed if we only wait long enough, there's no risk in the long run.

Can this be right? You've probably been told by some financial advisor that a long-term investor – say one investing for retirement 20 years away – should invest mostly in stocks, because over long periods stocks outperform bonds. Framed more carefully, the rationale is not because stocks outperform over long periods, but because stocks *will likely* outperform – or because they have in the past.

Framing is important: saying simply "stocks outperform" leaves no room for uncertainty, while inserting "will likely" acknowledges they may not. Consider an analogy to another type of risk, the risk your house will burn down.

You would not claim that insuring your house against fire is a waste of money because houses don't burn down – that's clearly false. But you'd also not justify forgoing insurance because your house will likely not burn down, or because, historically, no houses in your neighborhood have burned down.

Forgoing insurance is unwise, even though doing so would almost certainly save you money. You insure not because you expect your house to burn down, but because it might. And you prefer a sure loss you can afford – the insurance premium – to the small

EVA HAEBERLE/LAIF/REDUX

chance of a huge loss you can't afford. Only if you could afford the loss – say, because you're rich – might forgoing house insurance make sense.

We can (and should) think about investment risk the same way. It's not correct to say stocks outperform as a timeless truth, like "the sun rises in the east." While acknowledging that equities have historically outperformed bonds and likely will do so in the future, there's still a nontrivial risk they won't – and not just over short periods, but over long ones as well. It only makes sense to hold equities, then, to the extent the investor can afford the potential loss.

For financial economists, the above paragraph seems a no-brainer. To see why, let's assume the opposite and see that it implies something that makes no sense.

Suppose that over a sufficiently long holding period – say 30 years – there is no chance that a diversified portfolio of stocks will return less than a 30-year default-proof U.S. Treasury bond. If that were true, one could obtain what financial economists call riskless arbitrage – a sure profit with no money down and no risk, the financial equivalent of a perpetual-motion machine.

Imagine a bank that borrows $1 billion by issuing a 30-year bond, and invests the proceeds (but none of its own money) in stocks, held in a legal trust with dividends reinvested to secure repayment of the $1 billion plus accumulated interest on the bond in 30 years. First, recognize the bond is free of default risk in this scenario since it's guaranteed by the stock portfolio, which in 30 years is sure (by assumption) to be worth more than principal and interest owed on a default-free bond. Second, recognize there will be money left over after paying off the bond for the same reason. Having put no money down, the bank is certain to make a profit. Can this be possible?

Even if this were possible at some point in time, the very act of exploiting the opportunity – buying stocks and borrowing – would bid up stocks and interest rates, until it was no longer possible. Thus, the assumption that stocks can never underperform a default-free bond ultimately cannot be true. So, stocks are risky, even over the long run. In addition to the one-in-two chance they'll return less than expected, there is a nontrivial chance they'll return less than a default-free bond.

RICHARD LEVINE/CORBIS VIA GETTY IMAGES

To see why this is not a small problem for pension funds, consider how badly underperformance compounds over the long periods that pensions must operate. Suppose you're expecting to earn 7.5 percent per annum on a risky asset portfolio over 30 years, but instead earn 4.5 percent. If you were looking out just one year, you'd have 3 percent less than expected – a manageable problem. But what if the difference in returns is compounded over 30 years?

Investing $1,000 and earning the 7.5 percent expected every year for 30 years would result in an end balance of $8,755. If instead you earned 4.5 percent, the end balance would be only $3,745 – 57 percent less than expected. Now, suppose your average annual return over 30 years is an even-worse 1.5 percent. In this case, you would end up with only $1,563, or 82 percent less than expected. While such a dismal return is not likely, it is certainly possible. Indeed, Japanese equities have performed much worse than that over the nearly 30-year period since 1989.

The true cost of providing a secure pension benefit is more than what is reported, so funding is insufficient.

NO FREE LUNCH

Return now to what's wrong with the financial management of public pensions in the United States. It boils down to this: the plans, as currently managed, do not account for the cost of investment risk. As a result, the true cost of providing a secure pension benefit is more than what is reported, so funding is insufficient.

This means benefit payments down the road will depend to a significant degree on the ability of future governments to make up potentially significant shortfalls. The money incorrectly thought saved in smaller government contributions today is just the unaccounted-for market price of risk. That leaves the risk itself to be borne by someone in the future.

Consider, too, that since taking investment risk justifies assuming a higher asset return, it makes benefits appear cheaper. This creates a bias in favor of taking risk. And since the expected return is an assumption, not an observable parameter, there's a bias to be optimistic. Note that, if contributions were based on an unbiased expected return – and sufficiently large to track actuarial estimates – there would still be a 50 percent chance of shortfall. However, since the average public plan is only about 75 percent funded – and this is based on an optimistic 7.6 percent expected return – the reality is a much greater than a 50 percent chance of shortfall. For the public plans in Illinois, New Jersey and Kentucky, which are just 40 percent funded, the situation is more grave.

Yet another complication of ignoring the economist's view of risk: decisions about benefit increases are based on lowballed cost estimates. For example, given a choice between offering bumped-up pension benefits or higher salary in union contract negotiations, sponsors will be more inclined to improve benefits since future benefits are cheap. And if a plan seems to be more than 100 percent funded following several years of good asset returns, then benefit enhancements may seem covered, not requiring additional payment by the sponsor. Many plans did just this following the long bull market of 1982 to 1999.

Of course, once granted, benefit enhancements are owed and cannot be rescinded following market setbacks – unless, of course, the plan goes belly up and a judge is in charge.

There seems no limit to the ways in which ignoring risk undermines pensioners' security. One example: the deferred retirement option plan, under which some pension plans allow retirees to keep working while investing their pension checks in accounts earning a guaranteed rate equal to what the plan expects to earn on its risky portfolio – say 7 or 8 percent.

The Dallas police and fire pension offered such a program. When the plan's solvency was questioned, participants sought to withdraw their funds before the window shut – as it ultimately did. Indeed, thanks to the unfunded liabilities created by the plan, even basic benefits are now seriously at risk.

REALITY BITES

An income for life in retirement – the core feature of public defined-benefit pension plans – is a wonderful benefit, provided it is secure. It's also an expensive benefit, becoming more so by longer life expectancies and lower interest rates. But reducing funding and taking on more investment risk does not make it more affordable, just less secure.

Following the path of least political resistance, pension plans are typically guilty of (a) assuming a discount rate that makes payouts less than certain, and (b) allowing pension funds to slip far below 100 percent funding, even when the estimate is based on ill-advised assumptions about the discount rate.

The commitment of a future government to make up any shortfall is like the commitment behind a bond. And like a bond, a pension obligation may not be fully met if the burden is too great, as in the case of Detroit. But public pensioners, unlike bondholders, cannot manage credit risk – the risk of not getting fully paid – by diversifying.

No bond investors would sensibly bet all their savings on the credit of a single issuer if there were any risk of default. But pensioners with underfunded pension plans are unwittingly doing exactly that, and in many cases the credit of the sponsor is deeply suspect.

To fix this large and growing problem, two things need to be done. First, government accounting standards and public pension actuarial practice need to recognize the cost of risk, thereby revealing how much a secure pension benefit really costs. Second, public pensions need to be governed by independent trustees who (a) are technically qualified to exercise oversight, (b) have no conflicts of interest and (c) have a clear mandate to represent the interests of the beneficiaries.

While taxpayers and other stakeholders (including the aforementioned professional pension consultants) may still find it less painful to accept the risks than to come up with the cash to secure pensions, the consequences of kicking the can down the road would at least be more transparent.

If the sponsors were committed to making public pension benefits secure, they could transfer risk currently borne by pensioners, who can't manage that risk, to bondholders who can. If the government sponsor is not so committed – perhaps because the shortfall is already too large – it would be better to have the discussion about default sooner rather than later. Then all could consider how the obligations might be restructured to preserve as much value as possible, as fairly as possible.

It's only human nature to delay difficult decisions – especially if the current generation of deciders can dump the decisions on the next. Figuring out how we got in this pickle, alas, is much easier than whacking a pathway out.

Beating the Odds:
Jump-Starting Developing Countries

ILLUSTRATIONS BY
ARTHUR E. GIRON

Justin Yifu Lin and Célestin Monga, the authors of *Beating the Odds: Jump-Starting Developing Countries*,* are distinguished economists trained in elite Western universities. Lin's PhD is from the University of Chicago, while Monga has degrees from MIT and Panthéon-Sorbonne University. Moreover, they've both held positions of considerable responsibility in Western-oriented institutions. Lin served as the chief economist of the World Bank, while Monga is a managing director of the UN's Industrial Development Organization. ¶ But their current views certainl
economics, which asserts t
of Western-style good gove
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that offers a skeptical view of the importance that Western development economists place on suppressing corruption and building financial systems on the American and European model. Many readers, I suspect, won't be convinced. But all should understand that, as it becomes increasingly clear just how difficult sustained economic development has become for countries yet to achieve middle-income status, alternatives to Western approaches will be taken ever more seriously outside the West. — *Peter Passell*

ALEC:
Headline is "Beating the Odds" and in smaller type, "Jump-Starting Developed Countries"
Caption for Home page is: "Why development economists are just plain wrong."
Main topic: Books
Other topics: Governance, Economic Development, Economic Growth

Thomas Edison, the intrepid American inventor who brought to the world the lightbulb and held more than a thousand patents, had a simple rule for recruiting his engineers. He always invited the short-listed candidates (whom he assumed to all be technically capable of doing the job at hand) for lunch and carefully observed their behavior.

His objective was not to check their table manners, but to deduce their decision-making process from their most anodyne acts. A key indicator was his guests' propensity to add salt and pepper to their dishes without first tasting them. That very common and often unconscious gesture would disqualify any prospective candidate: it revealed a tendency to blindly act on one's instincts and to decide without checking the evidence.

Many researchers and policymakers working today on institutional development in developing countries are guilty of the Pavlovian behavior despised by Edison. They assume that, by simply looking at the current state of institutional development in industrialized countries, they know precisely what it means and how it can be measured. They mechanically compare political, administrative and financial institutions of countries regardless of their economic development levels. They naturally find gaps between poor and rich countries, and derive from those a generic reform agenda not based on evidence.

They also neglect lessons from the history of highly industrialized economies, all of which started their development success stories with suboptimal political, administrative and financial institutions. The broad (and somewhat abstract) intuition on the need to improve governance in all countries has strong moral and theoretical foundations: it is the *right* thing to do to sustain growth, ensure shared prosperity and build social trust and stable societies. But the conventional wisdom that low-income countries should therefore start their development with the governance institutions of high-income countries is both a non sequitur and a historical fallacy.

This chapter acknowledges that institutional development problems are indeed major impediments to economic growth. But contrary to conventional wisdom, it argues that they are often simply correlated with the level of economic development – and correlation is not causation. Seen from that perspective, the well-known weaknesses in the governance and financial sectors of many poor countries today often reflect their low level of development and the results of failed state interventions and distortions originating from erroneous economic development strategies.

Instead of posing first-world governance and financial institutions as the main prescription for sustained growth in third-world countries, economists should design policies that offer the maximum likelihood of success because they are consistent with comparative advantage and existing firm structure, while minimizing opportunities for rent-seeking and state capture. The dynamic development of competitive firms and industries will eventually lead to institutional development.

THE MYSTERY OF GOVERNANCE

Institutional development is generally acknowledged to be the reflection or result of

"good governance." Yet as A. Premchand, an economist at the International Monetary Fund once observed, governance is like obscenity "because it is difficult to define."

Perhaps the most comprehensive and authoritative intellectual source on the subject are the Worldwide Governance Indicators, produced in conjunction with the World Bank and widely respected in policy circles. They define governance as:

> The traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.

They identify six dimensions of governance: government effectiveness, regulatory quality, rule of law, control of corruption, voice and accountability, and political stability and absence of violence. That conceptual framework is then given empirical life through the use of data produced by a variety of think tanks, survey institutes, international organizations, nongovernmental organizations and private-sector firms. The WGI are therefore aggregate indices that combine the views of a large number of respondents, including those representing enterprises, citizens and experts in industrialized and developing countries.

Such a valiant effort to give meaning to the complex notion of governance is certainly respectable. But the theoretical and philosophical underpinnings of the WGI are highly questionable. First, assessing the quality of the traditions and institutions by which authority in a country is exercised is bound to be a subjective exercise. It is therefore susceptible to being a reflection of ethnocentric – if not paternalistic – perspectives. There is no reason to believe that such an assessment should be performed uniformly in China, Alaska and Zanzibar.

There will always be those who claim that all human societies share the same goals and have adopted global standards and broad principles of good governance embodied in internationally agreed covenants. Yet there will also always be the perception that these global standards are actually evidence of the Westernization of human values under the pretense of "universality." Both camps have some intellectual legitimacy. The reality that some who reject the good-governance agenda as a hidden attempt to Westernize the world may be defenders of authoritarian practices hidden behind the claim of cultural relativism does not necessarily invalidate all their arguments.

The WGI and other indicators of good governance or democratization do not really help escape the universalist-versus-relativist impasse. Moreover, even if one could come up with an ingredient list that satisfies both the universalists and the relativists, the belief that good governance can be captured quantitatively and measured through surveys will remain subject to debate.

Aggressive prosecution of corruption is taking place in many low-income countries, yet in those countries such legal actions are paradoxically considered further evidence of terrible governance.

Behavioral economics shows that people often err when asked to identify the constraints that affect even their most important activities. Econometric analyses show, for instance, that popular survey results such as the World Bank's Doing Business indicators do not correlate well with the actual constraints on private-sector performance. In other words, even the most successful businesspeople in the world generally fail to intuitively identify the real obstacles to productivity growth and enterprise development. If that is the case, how confident can one be about perceptions of others' well-being?

In fact, there are fundamental discrepancies between indicators of what is perceived as good governance and indicators of actual economic performance. These discrepancies also reveal fundamental issues of subjectivism and ethnocentrism that are reminiscent of the "orientalism" analyzed by Edward Said, the Palestinian-American who pioneered the field of post-colonial studies.

A good illustration of the problem can be found in countries' corruption-scale rankings, always one of the key pillars of the good governance agenda. Transparency International surveys basically show that the world is divided into two categories: the highly corrupt countries and the least corrupt, with a "good-governance" Western world surrounded by a "bad-governance" non-Western world. Transparency International is a reputable organization that does good work. But its surveys, which display a Manichean view of the world, are deeply disturbing.

Given that the fight against corruption is an important part of the good-governance agenda, it is perplexing that corruption has been prevalent throughout human history and still exists, often on a wide scale, in high-income countries. In recent years, France gave its former president Jacques Chirac a two-year suspended prison sentence for diverting public funds and abusing public trust. In the United States, four of the past seven Illinois governors were convicted and imprisoned – among them, Rod Blagojevich, who was convicted of numerous corruption charges including for trying to "sell" President Barack Obama's former Senate seat to the highest bidder. In Japan, many high-ranking government officials have been forced out of office throughout the postwar period amid corruption scandals. The problem has extended well beyond the political sphere and into a bureaucracy often considered one of the better managed in the world.

The typical response to the unflattering truth is to argue that high-income countries are "less" corrupt than others and their institutions are "stronger." But those arguments are hard to empirically validate. First, it is difficult to rigorously define what corruption means every time and everywhere, and to compare it across time and place. Many open transactions between lobbyists and policymakers in the United States, for example, would be considered corruption in other places in the world. Consider, too, that aggressive prosecution of corruption is taking place in many low-income countries, yet in those countries such legal actions are paradoxically considered further evidence of terrible governance. A case in point is that of Cameroon, where dozens of politicians and civil servants at the highest levels of power (including a former prime minister) have been convicted for embezzling public funds. Yet few analysts would consider Cameroon a good-governance country. To the contrary, the more senior government officials sent to jail, the more experts are convinced that Cameroon is profoundly corrupt.

Defining Corruption

The first clue to the inextricable difficulties of corruption analytics is the vagueness of the definitions that one can find in the technical literature. The most commonly used definition is the one by Andrei Shleifer and Robert Vishny, who define government corruption as:

> The sale by government officials of government property for personal gain. For example, government officials often collect bribes for providing permits and licenses, for giving passage through customs or for prohibiting the entry of competitors. In these cases they charge personally for goods that the state officially owns. In most cases the goods that the government officials sell are not demanded for their own sake, but rather enable private agents to pursue economic activity they could not pursue otherwise. Licenses, permits, passports and visas are needed to comply with laws and regulations that restrict private economic activity. Insofar as government officials have discretion over the provision of these goods, they can collect bribes from private agents.

The obvious question that this well-established definition raises is that of legality. What if there are no laws in place preventing government officials from making excessive or arbitrary use of their discretionary power? Does corruption intrinsically imply illegality? If it does, then the logical inference from the definition is that some practices may be considered "corruption" in some countries and not in others.

Corruption can be disaggregated along several dimensions. First, one must distinguish its prevalence, especially in large countries with decentralized political systems, where corruption can be widespread at the local government level, even if it is controlled at the central government level. Second, the purpose of improper actions characterized as corruption must also be taken into account. Bribes intended to influence the design and content of laws and regulations (state capture) must be differentiated from those intended to change or circumvent their implementation (administrative corruption). Third, there is a need to distinguish among the actor categories involved in various forms of corruption: when poor people are involved, it is often referred to as petty corruption as opposed to grand corruption, which involves high-level officials and political figures. Fourth, corruption may be of a different scale and nature depending on the administrative agency in which it takes place (schools, customs, health centers and so on).

Transparency International has chosen a more focused operational definition of the term: "the abuse of entrusted power for private gain." The organization further differentiates between "according to rule" corruption and "against the rule" corruption. Facilitation payments, where a bribe is paid to receive preferential treatment for something that the bribe receiver is required to do by law, constitute the first. The second is a bribe paid to obtain services the bribe receiver is prohibited from providing.

While Transparency International's definition of corruption is much clearer, it raises another series of problems. First, since bribe payments are not publicly recorded, it is virtually impossible to calculate their frequency or magnitude. Second, bribes do not always take monetary form – favors, presents, services and even threats and blackmail are just as common. These factors highlight other issues, such as the strength of the judicial system and its ability to effectively handle complaints at the lowest possible cost, the prevailing cultural and behavioral norms, and so on.

Corruption's social costs are even less quantifiable. As Transparency International points out:

> No one knows how much the loss of an energetic entrepreneur or an acclaimed scientist costs a country. Moreover, any estimated social costs in dollars would be inadequate to the task of measuring the human tragedy behind resignation, illiteracy or inadequate medical care.

In fact, much of the research on governance implicitly suggests that corruption can be observed only on a wide scale in countries under a certain income level. Although there is obviously recognition that corruption also occurs in high-income countries, it is treated as poor behavior by public officials or businesspeople who represent the exception and not the rule. These high-profile, headline-grabbing cases are considered outliers and therefore are either ignored or discounted by mainstream economic research. Nothing could be more misleading.

Defining and measuring corruption is a difficult task, not least because the definitions differ not only between countries but within them. For instance, while all of Japan is subject to one penal code, the United States has 50 different penal codes (one per state) as well as a national (federal) code. Moreover, Japan keeps detailed statistics on corrupt acts, whereas the United States has no centralized record-keeping for such acts.

Still, consider these statistics: between 1987 and 2006, U.S. federal courts convicted more than 20,000 government officials and private citizens involved in public corruption. The total convicted in the whole country is higher, since these numbers do not include convictions by states.

Changing Perceptions

By focusing on global governance standards that often reflect particular political, philosophical and ideological concepts of power, the traditional literature on governance has so far yielded few results. It has failed to offer actionable policies that poor countries could implement to foster inclusive growth in a pragmatic and incentives-compatible way.

In fact, good governance has been an elusive quest. Since the United Nations Commission on Human Rights identified transparency, responsibility, accountability, participation and responsiveness to the needs of the people as key attributes of good governance, the fight against corruption has become the most revealing and the most widely discussed aspect of governance. The academic pendulum on the subject has shifted from praising the increased economic efficiency that follows from corruption to stressing its many economic, sociopolitical and even moral costs.

Initial theoretical work on corruption underlined its positive role in development. Renowned scholars such as Nathaniel Leff (then at Harvard) and Samuel P. Huntington argued that corruption may make businesses more efficient by allowing them to circumvent bureaucratic procedures.

A second strand of the literature has attempted to invalidate these previous analyses. Gunnar Myrdal, the Nobel Prize-winning social scientist, argued that bribes may actually allow civil servants to reduce the speed with which they process business transactions, or that bureaucratic procedures should be seen not only as causes of rent-seeking activities but as their consequence.

Others have argued that, even taking at face value the suggestion that the most able economic agents in corrupt societies generate efficient allocation of resources through their actions, such talent allocation cannot be economically efficient. For instance, Susan Rose-Ackerman of Yale Law School observed that, once corruption is entrenched, it becomes so pervasive that it cannot be limited to areas in which it might be economically "desirable."

A third and most recent strand of research has focused on the negative effects of corruption (and bad governance more generally) on economic growth. Kevin M. Murphy, Andrei Schleifer and Robert W. Vishny suggested that increasing returns on unproductive rent-seeking may eventually crowd out productive investment. Paolo Mauro offered empirical evidence that the prevalence of perceived corruption may negatively affect economic performance. Such problems are said to be even worse in countries rich in natural resources – especially those in the developing world – where opportunities for rent-seeking activities are typically very high.

Despite the insights from all these various waves of research, the problems of corruption and governance and their implications for economic development remain unresolved. Empirical demonstrations of the impact of governance on economic growth are often based on subjective perception indices, the limitations of which are well known. Policy-makers in developing countries still have few actionable prescriptions for how to design policies to achieve their economic and governance goals. Moreover, a traditional recommendation for improving governance often involves curbing the power of political leaders – some of whom are not democratically selected. For low-income countries, a potentially more fruitful approach to tackling the problem would be to examine the possible determinants of good governance and to infer from these determinants which policies could limit opportunities for rent-seeking that in ways are compatible with political leaders' personal goals.

The Cost of the Good Governance Rhetoric

The obsession that low-income countries must have the same political institutions as high-income countries is perhaps well explained through the story of a fake corruption scandal surrounding the visit of the president of Congo to New York in September 2005. His official purpose was to give a 15-minute speech to the UN General Assembly. But questions arose when the hotel bill for the president and the 56 people in his entourage was leaked to the press. President Denis Sassou-Nguesso had spent $295,000 for an eight-night stay at the Palace Hotel on New York's Madison Avenue, including some $81,000 for his own suite.

The suite featured a master bedroom with a king bed, two additional bedrooms and six bathrooms. It also had its own private elevator. Media reports noted that the suite had a whirlpool bathtub and a 50-inch plasma television, and that room service charges on September 18 alone came to $3,500.

The hotel did not itemize the charges, leaving reporters to speculate about the room service menu, which included Dungeness crab, truffle crumbles, Scottish langoustines, pan-seared foie gras and braised snails in chicken mousse. They also made a big deal of the Congolese mission at the UN paying only a $51,000 deposit by check to secure the rooms. Presidential aides pulled out wads of $100 notes to settle the bill.

All the more stunning to reporters was that President Sassou-Nguesso was at the time the chairman of the African Union, representing the continent's 53 countries, and also negotiating with the World Bank and the International Monetary Fund for the cancellation of a large fraction of Congo's debt on the grounds that the country could not afford to repay it. His government was also talking to the Paris and London Clubs, informal groups of official and private creditors respectively, whose role is to coordinate sustainable solutions to debtor countries' payment difficulties.

The news was received with shock and anger, especially by people in Congo, who probably would have liked their tax money spent on other priorities. Leaders of non-governmental organizations and anticorruption movements wrote letters to the World Bank's president urging him to oppose any debt relief operation for Congo until the country's leaders could demonstrate better public finance management skills. Global Witness, a well-known anticorruption group, issued a report claiming that Congo's oil wealth has "for too long been managed for the private profit of the elite rather than for the benefit of its entire population."

Not surprisingly, Paul Wolfowitz, then president of the World Bank, was more than inclined to bow to the pressure. It took a forceful response from the office of the executive director for francophone Africa on the board of directors of the World Bank to refocus the debate on Congo's debt relief on the real issues at hand.

Let's step back and look at the situation in the context of normal diplomatic practices. Why the outrage about a hotel bill of a few hundred thousand dollars for a large presidential delegation on an official visit to the United Nations? After all, hotel suites are expensive in New York in September, especially in the small number of luxury hotels where

A traditional recommendation for improving governance often involves curbing the power of political leaders – some of whom are not democratically selected.

foreign heads of states are forced to reside for security reasons when they attend the annual UN meetings. Would those who cried foul about the hotel bill have preferred that the president of Congo and his entourage settle in a two-star hotel somewhere in New Jersey or Connecticut while attending the summit?

Is Incompetence Worse Than Corruption?

There are certainly many important economic and even governance issues to be discussed about Congo and other low-income countries. But the focus on the hotel bill obscured the real questions of whether the public policies implemented by his government were sound enough to bring strong economic growth and prosperity to his people. While the hotel bill might have been high, the only reason it was disclosed to the press was that some of Congo's creditors had filed lawsuits over business debt repayment.

These were all "vulture" investment funds that make profits by buying up poor countries' debt at discount prices. Using a judgment from two British High Court judges that found Congolese officials to be "dishonest" about their country's debt, the fund managers had subpoenaed President Sassou-Nguesso's hotel bill and leaked it to the media. Yet few newspapers that reported the sensationalist tale devoted time and resources to investigate the vulture investment funds – what they are, how they function and how poor countries around the world should deal with them.

Would the media have shown the same interest in the story if the hotel bill was run up by a leader from a country with a better reputation? Would these questions have arisen if the president of an industrialized country had spent the same amount of money for a stay in the city? Was the problem merely Congo's intolerable poverty level? Or were the attacks against Sassou-Nguesso motivated by ignorance, class prejudice, racial prejudice and so on?

Perhaps because he had read news reports and briefing memos on issues such as the Sassou-Nguesso hotel bill story, Barack Obama used his first official trip to Africa (Ghana in July 2009) to speak out against corrupt leaders:

> No country is going to create wealth if its leaders exploit the economy to enrich themselves or if police can be bought off by drug traffickers. No business wants to invest in a place where the government skims 20 percent off the top. … No person wants to live in a society where the rule of law gives way to the rule of brutality and bribery. ... And now is the time for that style of governance to end.

Those words were met with polite applause. But many African leaders and intellectuals objected to the paternalistic tone and the perceived double standard that underlined Obama's public ethics lecture. Festus G. Mogae, the former president of the Republic of Botswana, observed that Obama's critique of African corruption on his first official visit there seemed quite selective:

> [Obama] has been to the Middle East, to Turkey, to Russia, to Europe, to Britain – Britain where Parliamentarians have been doing their own thing – [to] Germany where Siemens has been indicted for corruption, [to] Russia and the Middle East, [places] which are not known for their anti-corruption probity. … So, while it is right and proper that the president should have raised the issue of corruption, the fact that he only raised it when he got to Africa has the effect of perpetuating the misconception that corruption exists only in Africa.

The story of President Sassou-Nguesso's hotel bill illustrates the confusion and fantasies that have too often plagued public policy when the good governance obsession leads to distracting public discourse and focus on the wrong development objectives. Such stories sideline the much bigger economic issues of public investment priorities, flawed debt

management strategies and economic policy mistakes throughout the decades that are much costlier to Congo.

Similar stories can be told about many other countries. In the neighboring Democratic Republic of Congo (DRC), the public debate about corruption and good governance was dominated in 2013 by the story of 15 government officials who pocketed $52 million in mining fees in 2012. Again, that was a valid issue. But the public debate never tackled the much bigger problem: the DRC receives less than 5 percent of revenues generated by mining firms operating in the country, while the ratio is as high as 60–80 percent in the Persian Gulf countries and African countries such as Algeria. Honest incompetence and bad economic strategies are neglected, despite their potentially serious consequences on productivity and growth.

Likewise, the African Union has devoted many resources to promoting the findings of its Report on Corruption released in 2012, which indicates that an estimated $148 billion annually is lost to corruption. Clearly, such waste deserves publicity and reflection. But the sum should be put in the context of the much larger sums of money wasted on unproductive public expenditures.

An Incentives-Compatible Policy Framework for Governance

Most studies on the determinants of good governance go back to arguments similar to those made by either Gary Becker or Anne Krueger. Becker analyzed corruption as a purely illegal activity and suggested that criminal offenses must be viewed as "economic activities" with external effects, and with punishment conceived as a form of taxation. From that general framework he conjectured that the probability of committing a crime depends essentially on the penalty imposed and on the probability of being caught. Furthermore, the penalty's deterrent value depends on the authorities' willingness and capacity to enforce laws and on people's acceptance of the country's institutions. This implies that effective corruption enforcement rules, and good governance in general, can take place only in countries with political stability and transparent rules.

In Becker's insightful analysis, corrupt agents expend resources to steal, and society, the victim, experiences negative external effects. He suggests that prohibition rules be combined with fines or other punishment to internalize the negative externality.

Unfortunately, this kind of after-the-fact remedy to corruption may arrive too late. And it may be ineffective in countries where the externality-generating activities (that is, corruption) are not easy to identify owing to prevailing social norms and practices, or may be costly to curb. In almost all poor countries, the costs of running a well-functioning national judicial system are often far beyond what the public sector can afford. The problem is compounded in many African countries where corruption is embedded in societal, economic and power relations, and virtually all state institutions, including the judicial system, are caught in the low-equilibrium dynamics of what Richard Joseph called "prebendal politics."

But corruption isn't just something that happens to poor countries. If one looks at corruption in historical perspective, it is clear that today's high-income countries went through the same – or even worse – bad governance episodes now observed in sub-Saharan Africa. In the fascinating book *Corruption and Reform*, Harvard's Edward Glaeser and Claudia Goldin analyze various patterns of bad governance in the history of the world's greatest democracy. The results are disconcerting.

> Conventional histories of 19th- and early 20th-century America portray its corrupt elements as similar, and at times equal, to those found in many of today's modern transition economies and developing regions. Nineteenth-century American urban governments vastly overpaid for basic services, such as street cleaning and construction, in exchange for kickbacks garnered by elected officials. Governments gave away public services for nominal official fees and healthy bribes.

These elements provide a crucial clue to the problems of corruption and governance: they are endogenous to the level of economic development. In other words, low-income

Good political governance should not be seen a precondition for good economic performance. Sustained economic growth, employment creation and poverty reduction can be achieved even in very poor governance environments.

countries are by definition places where (perceived) corruption is a problem, while their governance indicators improve with their economic performance. It is unrealistic to expect the Democratic Republic of Congo, a country with less than $500 income per capita, to build governance institutions that are perceived as effective as those of Norway, where per capita income exceeds $70,000.

What is crucially needed, then, to fight corruption and improve governance in a low-income country is a development strategy that offers few opportunities for state capture and rent-seeking activities. If a government adopts a comparative-advantage strategy, firms in the priority sectors will be viable in an open, competitive market, and the government will not need to protect or subsidize them.

What does this leave us? Good political governance should be an important public policy goal and be set freely by the all countries' people and leaders. It should not, however, be seen as a precondition for good economic performance. Sustained economic growth, employment creation and poverty reduction can be achieved even in very poor governance environments. Moreover, good political governance is always an unfinished process.

Good economic governance is a noble goal, and its general principles can be widely shared across nations and cultures. But operationalizing it is likely to vary widely across place and time. To succeed, a policy agenda is needed that focuses on using limited state resources strategically and wisely. Focus areas should include setting economic policy to ensure that only activities that are consistent with comparative advantage are encouraged; ensuring that government at all levels has the tools, incentives and discipline to facilitate public-private partnerships in the development of competitive industries; and setting rules of the game that are enduring and effective.

Following the policy-oriented approach suggested by Anne Krueger, the empirical literature has identified seven factors as the main causes of corruption:

- **Trade restrictions**, which make the necessary import licenses very valuable and encourage importers to consider bribing the officials who control their issuance.
- **Government subsidies** that are appropriated by firms for which they are not intended.
- **Price controls** whose purpose is to lower the prices of some goods below market value (usually for social or political reasons) but create incentives for individuals or groups to bribe officials to maintain the flow of such goods or to acquire an unfair share at the below-market price.
- **Multiple exchange rate practices and foreign exchange allocation schemes.** Differentials among these rates often lead to attempts to obtain the most advantageous rate, although that rate might not apply to the intended use of the exchange. Multiple exchange rate systems are often associated with anti-competitive banking systems in which a particular bank with strong political ties makes large profits by arbitraging between markets.
- **Low wages in the civil service relative to wages in the private sector**, which often lead civil servants to use their positions to collect bribes as a way of making ends meet – particularly when the expected cost of being caught is low.
- **Natural resource endowments.**
- **Sociological factors such as ethnolinguistic fractionalization.**

Given that virtually all governments in the world – including those in successful democratic countries – regularly intervene in their economies, the important question is which particular policy circumstances provide the best incentives for good governance? Lin's book *New Structural Economics* attempts an

answer. It suggests the gradual lifting of trade restrictions, price controls and multiple exchange rates, recognizing that such interventions may be temporarily needed to protect firms in sectors that lack a comparative advantage. It advocates carefully targeted incentives (of limited amount and time), allocated in a transparent manner to compensate for the externality generated by pioneer firms (even in industries that are consistent with comparative advantage).

Such a framework ensures that corruption opportunities are minimized. It favors government intervention only in industries where firms are viable in open, competitive markets and whose survival do not depend on large subsidies, or direct resource allocations through measures such as high tariffs, quota restrictions or subsidized credit. In the absence of large rents embedded in public policies, there will not be distortions that become the easy targets of political capture. The likelihood of the pervasive governance problems that are observed in many low-income countries can be much reduced if governments facilitate the development of new industries that are consistent with the country's changing comparative advantage, determined by its changing endowment structure.

The goals of most political leaders everywhere are typically to stay in power as long as possible and to leave a positive legacy. Most leaders understand that promoting economic prosperity is the best way to achieve these goals. Development policy based on new structural economics, which advises governments to facilitate the entry of private firms into sectors with comparative advantages, can reduce corruption and bring growth. Good governance will be the result of such a strategy, because there is no need to create rents that subsidize and protect firms in the priority sectors. Therefore, it is an incentives-compatible way for political leaders in developing countries, including those in poor countries, to address challenging governance issues.

"UNDERDEVELOPED" FINANCE: THE ILLUSIONS OF MIMICRY

On the list of the most recurrent obstacles to growth and poverty reduction, the next culprit often singled out in the literature is limited access to capital. Credit appears to be a major bottleneck for business creation and development. Moreover, bankers and financiers are universally considered villains whose greed and shortsightedness are such that entrepreneurs cannot expect their support in the drive for value creation.

In her compilation of jokes about them, Anna White (the City Diary editor of *The Telegraph*) recounts the widely shared belief that "bankers are people that help you with problems you would not have had without them." She also tells the story of a man who visits his bank manager and asks, "How do I start a small business?" The manager replies, "Start a large one and wait six months."

It is not surprising, then, that the weak financial systems that are so prevalent in low-income countries are perceived as impediments to growth and poverty reduction. Following the pioneering work of Raymond Goldsmith, Ronald McKinnon and Edward Shaw, a rich research literature has advanced the view that the amount of credit the financial sector can intermediate is an important determinant of economic performance.

Here again, the theoretical case seems quite strong. Economic prosperity, the result of improvements in physical and human capital and productivity, depends on the efficient use of productive assets – and on including large portions of the population in that process. Effective financial intermediation is therefore essential, as agents with net savings (whether domestic or foreign) should be encouraged to provide funding at optimal cost to support private investment. Both savers and investors face risk and uncertainty, and the financial system can help them mitigate it – or capitalize on it. By the same token, savers are generally unable to select the investment projects that best match their personal risk tolerances, and without pooling their money they cannot take advantage of increasing returns to scale in investments.

Asli Demirgüç-Kunt and Leora Klapper sum up the intellectual consensus on financial systems' capacity to reduce poverty:

> Inclusive financial systems – allowing broad access to financial services without price or non-price barriers to their use – are especially likely to benefit poor people and other disadvantaged groups. Without inclusive financial systems, poor people must rely on their own limited savings to invest in their education or become entrepreneurs – and small enterprises must rely on their limited earnings to pursue promising growth opportunities.

But empirical research tends to show that the relationship between financial development, economic growth and poverty reduction depends on many other factors, such as the country's development level, the financial structure and existing regulations. Stephen Cecchetti and Enisse Kharroubi investigate one key question:

> Is it true [that financial development is good for economic growth] regardless of the size and growth rate of the financial system? Or, like a person who eats too much, does a bloated financial system become a drag on the rest of the economy?

From a sample of developed and emerging market economies, they show that financial development promotes growth only up to a point, after which it actually reduces growth. Strikingly, they also show that a *fast-growing* financial sector is detrimental to aggregate productivity growth in advanced economies.

These findings raise a host of important questions for policymakers ranging from the criteria under which financial institutions are established and allowed to expand, to the instruments they can use to mobilize savings. Financial intermediation, everyone agrees, creates strong externalities that can be either positive (such as provision of information and liquidity) or negative (such as excessive risk-taking and systemic crises).

The Quest for Appropriate Financial Institutions

There is a vast literature analyzing the relative advantages of various banking structures. But there is no consensus on the strengths and weaknesses of alternatives in promoting economic growth. Nor is there consensus on the strengths and weaknesses of different financial regimes in different country settings. The reasons for these gaps are the neglect of the specific characteristics of the real economy at each level of development and the corresponding needs in terms of financial intermediation.

Research shows that financial markets tend to outpace banking activity as income per capita rises. The literature has focused on the causal relationship between financial structure and economic growth – that is, whether a market-based or bank-based financial structure is more conducive to growth. Banking partisans argue financial markets provide much weaker incentives for agents to collect information relevant to investors' prospects before the fact or to monitor borrowers (or stock issuers) after the fact. Thus securities markets are at a disadvantage in alleviating the asymmetry of information between providers and users of capital. It follows that a bank-based structure should perform better in allocating resources and promoting economic development.

Not surprisingly, those who favor market-based financial systems focus on the problems created by powerful banks. Banks may gain huge influence over firms, undermining firm productivity and economic growth. In addition, banks tend to be more cautious by nature, and so bank-based systems may stymie financial innovation and impede economic growth. Furthermore, financial markets are often seen as providing richer and more flexible tools for risk management – derivatives and the like – while banks can provide only basic risk-management services.

The technical literature on banking tends to focus on whether competitive or monopolistic banks are better for economic growth. Some authors suggest that monopolistic banks tend to extract too much rent from borrowers (by charging above-market interest, etc.), undermining investment incentives. By the same token, monopolistic banks tends to pay lower rates of interest to depositors, and thus reduce the amount of capital they intermediate, which in turn slows economic growth.

But others argue that monopolistic banks have more incentive to collect information, screen and monitor borrowers, and form long-term relationships with borrowers. Such borrower-lender relationships are especially valuable to startups. In a competitive banking sector, by contrast, borrowers can more easily shift between lenders, so banks may have less incentive to forge such long-term borrower-lender relationships. As a consequence, market concentration in banking may give the most productive projects a better chance to get financed.

Empirical studies on this topic are far from conclusive. Some show a positive relationship between banking concentration and stability. Others find that new firms grow faster in economies with a more concentrated banking sector, while old firms benefit from a more competitive banking structure.

Despite their diverging conclusions, these two schools of thought share a similar – and flawed – research perspective. They typically start from an examination of various institutional arrangements and then discuss the possible impact of financial structure on economic development. Yet the impact of financial systems on growth may not be appropriately determined if the analysis is isolated from the examination of how the financial structure itself is determined.

While the research on the impact of banking structure on market concentration is quite substantial, the topic of how the size distribution of banks affects growth has been neglected. This flies in the face of the well-established fact that small businesses, the dominant form of business operations in developing countries, usually have difficulty obtaining loans from big banks – implying that the distribution of banks by size does affect allocative efficiency.

A few studies have looked at the issue from a very different perspective, examining the mechanisms that determine financial structure. Raghuram Rajan and Luigi Zingales, for instance, apply interest group theory to explain differences in financial structure in countries at similar stages of development. Others have emphasized the legal system's importance in shaping financial structure, arguing that effectively implementing the law is more critical to the operation of financial markets than of banks. Thus a bank-based system will have advantages in countries with weak legal systems.

The impact of financial systems on growth may not be appropriately determined if the analysis is separated from the examination of how the financial structure itself is determined.

This logic does not, however, explain why financial structure is usually different in countries with similar legal origins but at different development stages. Or why the financial structure in a given country changes as the country's economy develops. In fact, any effective theory should take into consideration the financial structure's endogeneity when analyzing the relationship between financial structure and economic development.

To sum up, much of the literature adopts a supply-side approach. It starts from an examination of the characteristics of various financial arrangements and then discusses the likely effects of different financial systems on economic growth. We think it is important to pursue a radically different demand-side approach – one that starts from the analysis of the real economy's characteristics and the real economy's demand for financial services. A financial structure's effectiveness should be measured by one important criterion: whether it can best mobilize and allocate financial resources to serve the real economy's needs.

Redefining Optimal Financial Structure

Empirical research shows that there is virtually no country – even among industrialized ones – where securities markets actually contribute a large part of corporate financing. Indeed, Colin Mayer studied eight developed countries and concluded that the average net contribution of their securities markets was close to zero. This does not necessarily imply that equity markets do not perform an important function, Mayer writes. "They may promote allocative efficiency by providing prices that guide the allocation of resources … through reallocating existing resources via, for example, the takeover process."

The financial-sector reforms were expected to raise savings and investment levels, reduce macroeconomic instability, increase the rate of growth and create employment. These objectives have generally not been achieved.

Two dimensions of financial structure critically affect financial systems' efficiency in economic development: first, the relative importance of banks and financial markets, and second, the distribution of banks of different sizes. Banks are the predominant type of financial intermediary in low-income countries. Their mechanisms for mobilizing savings, allocating capital and diversifying risks are very different from those of financial markets. Therefore, the relative importance of banks and markets constitutes the most important dimension.

Among banks, there is an obvious distinction between the way in which big banks do business and how small banks operate. This has implications for access to services, especially lending services, for different size firms. Banks were long regarded as central to promoting growth and poverty reduction. But in the face of widespread corruption and bank failures in the 1970s and 1980s, there was disillusionment with their role, most notably in developing countries. As a result, many influential development institutions, such as the World Bank, shifted their policy advice and advocated the use of both security markets and banks in promoting growth. In fact, a central feature of the economic reform implemented in the Washington Consensus framework was the dismantling of the traditional development finance model (based on bank-based systems, directed credit, public development banks, closed capital accounts, capped interest rates and active monetary intervention) that had been established in developing countries in the postwar era.

Small banks with very limited assets cannot afford to make large loans; they would have to bear much higher risk resulting from concentrated investments. Large banks are able to make larger loans and achieve better risk diversification. Since the transaction cost for making a loan is, at least to some degree, independent of loan size, large banks understandably prefer making loans to large firms rather than small ones. Large banks tend to focus on large businesses, while small banks specialize in lending to small businesses. Thus the distribution of big banks and their smaller counterparts can have a substantial effect on the banking sector's performance.

The new received wisdom aims to reflect

the imperatives of financial development. It has been influenced by financial market liberalization that is unfolding in the advanced economies, which have moved away from national bank-based systems toward open capital markets – at least until the 2008 Great Recession when the pendulum switched to the other extreme. Conservative governments in the United States and Europe abruptly changed gears and adopted new laws and regulations to rein in financial markets.

The financial-sector reforms implemented in developing countries around the world over the past decades were expected to raise savings and investment levels, reduce macroeconomic instability, increase the rate of growth and create employment. These objectives have generally not been achieved. Instead, the years since the mid-1990s have been marred by several financial crises and a decline in funding for productive enterprises – especially small and medium-size enterprises.

Recent analytic work by Justin Yifu Lin, Xifang Sun and Ye Jiang shows that each institutional arrangement in a financial system has both advantages and disadvantages. Equity markets become more active relative to banks as a country becomes richer; small businesses have no access to equity markets and generally have less access to large banks' loan facilities.

The factor endowment in an economy at each stage of its development determines the optimal industrial structure in the real sector, which in turn constitutes the main determinant of the size distribution and risk features of viable enterprises, with implications for the appropriate institutional arrangement for financial services. Therefore, there is an endogenously determined optimal financial structure for the economy at each development stage.

While poor regulation and supervision may cause financial crises, a serious mismatch between the financial structure and industrial structure will reduce efficiency in mobilizing and allocating financial resources. In developed countries where large, capital-intensive firms and high-tech firms lead, financial systems dominated by securities markets and big banks will be more efficient in allocating financial resources and promoting economic growth. In developing countries, where small and less risky labor-intensive firms are the main engines of growth, the optimal financial structure will be characterized by the dominance of banks, especially small local banks. The optimal financial structure for any country changes as the economy develops.

The major policy challenge is selecting the appropriate framework for developing sustainable and effective financial institutions. In this regard, governments have an important role to play. Both equity markets and banks require regulation and supervision to reduce the occurrence and severity of financial crises. Although a country's endowments and the resulting optimal industrial structure are the most fundamental force shaping its financial structure, government policy will also affect the evolution of the financial system. In fact, strategies promoted by governments are among the most important factors leading industrial structures and financial structures to deviate from optimality in terms of growth potential.

Policymakers in developing countries should be mindful of a particularly costly type of hidden distortion that follows from replicating the financial systems in developed countries without fully considering the real economy's demand for financial services. Just like perception-based indicators of good governance, financial development is a function of a country's economic development level – not a prerequisite to performance.

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Main topic: Middle East
Other topics: Economic Development

Still Digging Out

The Economics of a Palestinian Future

BY JACOB UDELL AND GLENN YAGO

ILLUSTRATIONS BY HANNA BARCZYK

The Israeli-Palestinian struggle reached the front burner of global geopolitics once again this winter, when the departing Obama administration declined to veto a UN Security Council resolution condemning Israel’s settlement construction and the incoming Trump administration responded with a show of solidarity with the Netanyahu government. But, as this latest episode in more than a decade of diplomatic frustration since the 2005 disengagement from Gaza has illustrated once again, what happens below the diplomats’ radar may have more to do with eventual economic outcomes than the latest efforts to untangle the Gordian knot. Developments on the international stage have a way of distracting from pressing fiscal, trade, environmental, business and infrastructure issues that, if managed well, could improve daily life and even make a political deal more plausible.

Under the mantra of “nothing is agreed until everything is agreed,” economic development is given short shrift. Yet development through market building on the ground is central to the success of nascent states. Job creation and growth buttress diplomatic initiatives and provide incentives for negotiated solutions. More than ever, then, an economic plan laid out by common Palestinian and Israeli interests could make a bigger difference in building transactional trust than another roll of the political dice.

Addressing growth is long overdue for the Palestinian economy, which has experienced a lost decade. Since 2005, real average wages have decreased by some 10 percent, while unemployment remains at around one-quarter of the labor force, and average GDP growth lags behind population growth by 2.6 percent per year.

That last number is arguably most dispiriting. The Palestinian Authority's economic performance is at the bottom of the Arab world and less than the average growth rate among what the World Bank defines as heavily indebted poor countries.

Donor and public sector expenditures – at the top of the agenda of ways to buffer the political pain of compromise for the Palestinians – are currently not designed to sustain economic expansion. International aid and donations shift rapidly from year to year, leading to uncertainty and inefficient allocation of funds. After the Israeli disengagement from Gaza in 2005, the rise in donor aid, which reached almost 32 percent of GDP in 2008, initially fueled rapid economic growth. However, the subsequent decline of aid and the failure to apply systematic efforts to replace it with market investment have exposed the fundamental vulnerabilities of the Palestinian economy. If donor grants simply fill the gap left by a lack of efficient market incentives, they do little to help private investors build management expertise or bring about sustainable job creation.

Exacerbating the instability, donor aid pledged to the Palestinian Authority often does not materialize. For instance, only 35 percent of the $3.5 billion in Cairo Conference funds promised to the Palestinian Authority for Gazan reconstruction have been delivered. Yet, overall, despite the shifts and shocks, foreign aid in 2015 continued to make up more than 30 percent of the PA's $4.3 billion annual budget. This aid model distorts Palestinian economic development and hampers growth. Robust development requires investment, leveraged and strengthened by aid.

In the absence of a political breakthrough, investment – everything from housing to waste treatment – must propel aggregate demand and provide the base for economic development. The needs of the Palestinian economy are urgent and will only grow more intractable with delay.

JOB CREATION AND PRIVATE SECTOR FINANCE

While the poverty rate in the West Bank and Gaza has fallen slightly in the past decade, the improvement is largely a result of public and private transfers, not job creation. Indeed, the West Bank and Gaza remain highly dependent on cash remittances from Palestinian workers in Israel and abroad, as opposed to local employment and production. From 1993 until 2013, remittances have run as high as 34 percent of the GDP, making this the economy with the second greatest reliance on cash remittances (as a portion of income) in the world.

Looking further, it's worth noting that remittance inflows for investment amount to only about 13 percent of the total, whereas household transfers – money sent back home by family and friends for expenses – constitutes 30 percent, and workers' compensation, which are paychecks from Israel or abroad used for domestic consumption, represents over half. These data illustrate the extreme dependence of residents of the West Bank and Gaza on work in Israel and financial support

JACOB UDELL is a research analyst and **GLENN YAGO** is senior director at the Milken Innovation Center at the Jerusalem Institute for Israel Studies. This article updates an earlier analysis published in the *Review* in the third quarter of 2005.

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PALESTINE'S LOST DECADE

KEY DEVELOPMENT STATISTICS IN THE WEST BANK AND GAZA

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
GDP Constant $US (Millions)*	$4,796.7	4,609.6	4,913.4	5,212.1	5,663.6	6,122.3	6,882.3	7,314.8	7,477.0	7,449.0
GDP Per Capita Constant $US*	$1,459.4	1,360.1	1,406.0	1,449.1	1,529.8	1,606.4	1,752.5	1,807.5	1,793.3	1,734.6
Population	3,508,126	3,611,998	3,719,189	3,825,512	3,935,249	4,048,403	4,168,860	4,293,313	4,420,549	4,550,368
Population Growth	2.96%	2.96	2.97	2.86	2.87	2.88	2.98	2.99	2.96	2.94
GDP Per Capita Annual Growth	7.5%	−6.8	3.4	3.1	5.6	5.0	9.1	3.1	−0.8	−3.3
Poverty Rate	29.5%	30.8	31.2		26.2	25.7	25.8			
Unemployment Rate	26.0%	23.6	21.6	26.0	24.5	23.7	21.0	23.0	23.4	26.2
Real Wage Index*^	66.8	66.1	68.2	66.5	63.1	64.1	60.4	58.6	58.5	58.0

SOURCE: Palestinian Monetary Authority & World Bank   * Assumes a base year of 2004.   ^ Uses PMA's Consumer Price Index.

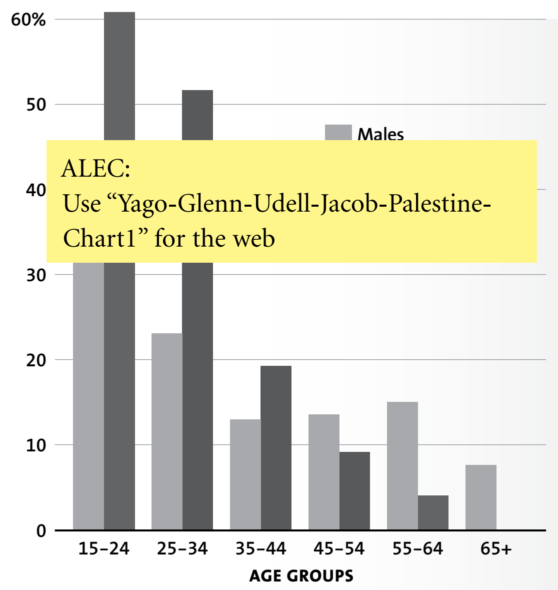
from family members living abroad for their basic consumption.

By the same token, a close look at labor statistics reveals a number of additional troubling trends. Though the labor force participation rate is currently at its highest since 2000 (at an unimpressive 46 percent), it has been accompanied by an overall spike in unemployment – implying that the net entry of job seekers into the market exceeds the ability of the economy to create employment.

Meanwhile, the Palestinian Authority has also become the employer of last resort, with 23 percent of the workforce on its rolls. The wave of youth entering the labor market in the past decade, coupled with the frictional and structural unemployment of the adult population and almost nonexistent job growth, has left youth unemployment at alarming levels. Since 2001, for instance, unemployment among males aged 15-24, which seems to function as a leading indicator of civil unrest, has averaged 35 to 40 percent and reached 43 percent in 2014.

Job creation remains the most pressing imperative to make up for the missed diplomatic opportunities of the past decades. As the IMF recently pointed out, the combination of volatile donor aid, political uncertainty and limited policy innovation is creating a situation in which likely growth

UNEMPLOYMENT RATE IN WEST BANK AND GAZA, 2015



SOURCE: The authors

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AND GAZA AND NEIGHBORS

PERCENTAGE OF POPULATION OVER AGE 15

	HELD AN ACCOUNT AT A FINANCIAL INSTITUTION	BORROWED FROM A FINANCIAL INSTITUTION IN THE PAST YEAR	SAVED AT A FINANCIAL INSTITUTION IN THE PAST YEAR
Egypt	14.3%	6.3%	4.1%
Israel	90.0%	40.5%	53.5%
Jordan	24.6%	13.6%	3.8%
Lebanon	46.9%	15.6%	17.5%
West Bank and Gaza	24.2%	4.2%	5.1%

SOURCE: World Bank Financial Inclusion Data

(around 3 percent) remains insufficient to absorb the ballooning numbers of Palestinians of working age. The resulting rise in unemployment and fall in living standards can only complicate initiatives toward a political settlement. So improvements in Israeli-Palestinian economic cooperation should remain a high priority, whether one sees the goal as peace or just the improvement of Palestinian living standards.

One key to job creation is structural change in both capital and labor markets. As it currently stands, the Palestinian economy is driven mostly by consumption, which represented over 90 percent of GDP in 2014 – a disturbingly high figure by the standard of successful developing countries. Production, not consumption, is the true source of the wealth of nations, especially new ones, and the Palestinian private sector must create conditions in which businesses can accelerate wealth creation to finance future production. Yet the Palestinian financial sector, while expanding, does not have the depth or breadth to meet legitimate private credit demand. Private lending represents just one-quarter of total credit in the West Bank and Gaza, as opposed to three-quarters in Jordan and 95 percent in Israel. In fact, most of the growth in credit has

of loans to the public sector: the government relies upon the funds of the Palestinian banks to cover its budget deficits.

SEPARATION VERSUS INTEGRATION

Oslo-driven visions of a Palestinian state as a viable economic entity were premised on the eventual integration of the Palestinian and Israeli economies. But the Second Intifada and the ill will built up over the past decade have led to a reconsideration of the united-we-stand/divided-we-fall assumption. In our view, it would serve neither Israelis nor Palestinians to cling single-mindedly to the goal of European-Union-style integration. Normalization of economic relations between Israel and an independent Palestinian state will surely depend on an agreement that facilitates trade and capital flows, but this need not imply full integration of labor or capital markets.

Focusing on the years of relative calm before the Second Intifada, it becomes clear that Palestinians' economic dependence on Israel was a mixed blessing. During the Oslo period (1993-2000), the GDP of the Palestinian economy grew by 20 percent – a seemingly reasonable number until one remembers that truly explosive population growth led to a reduction in output per person of 8 percent. By the same token, the higher wages paid to Palestinians by Israelis certainly pleased the recipients. But it also put pressure on wages and prices in lower-productivity businesses in the territories, making it more difficult for homegrown Palestinian enterprises to take root or to compete on an arm's-length basis in foreign markets. Gross capital formation, the key to productivity growth, remained dangerously low in the years since 2006 – between 20 and 25 percent of GDP.

The Palestinian territories' trade deficit is also a product of dependence on Israel and a lack of diversification of its trade partners. Israel is the biggest market by far for Palestinian goods, accounting for some 85 percent of Palestinian exports, which highlights the lack of Palestinian business development in the markets of Europe and the rest of the Middle East. Israel is also the territories' major supplier, accounting for 60 percent of total imports.

There is some evidence that local economic development built on sound institutions is possible. For instance, the Palestinian Investment Fund, a sovereign wealth fund with close to $800 million in assets, has become more transparent since it was mired in corruption scandals a decade ago. The fund has recently engaged in renewable energy financing, with the goal of investing $150 million in 10 solar plants in the West Bank and Gaza.

Nevertheless, investment figures remain discouraging. And while considerable sums flow into the territories from overseas Palestinians, there are no "diaspora bonds" or other vehicles to facilitate investment by Palestinian ex-pats (whose wealth estimates by the World Bank have varied from $40 billion to $80 billion). One mark of a lack of confidence in the economy: Palestinian investment abroad in 2015 was $5.9 billion – $1.3 billion more than foreign investment in Palestine.

AN ECONOMIC ROAD MAP FOR A FUTURE PALESTINE

More than a decade ago, at the 2005 Milken Institute Global Conference in Los Angeles, we asked a spectrum of business and political leaders from the United States and the Middle East to brainstorm ways in which business could effectively privatize the peace process. Today, those ideas, together with lessons learned from economic development elsewhere, can still provide the outline of an economic road map for a future Palestine. We divide the strategy in three:

• Looking outward to its competitive advantages in the region

• Looking inward to locally led investment in key sectors

• Looking up to ensure that the financial infrastructure exists for private sector growth

Looking Outward: Sources of Competitive Advantage

A future Palestine could take a leaf out of Israel's playbook, focusing on its strengths to overcome its weaknesses. Like Israel, Palestine lacks natural resources. But it does have a wealthy diaspora, a cultural commitment to education, and strong entrepreneurial and trading traditions vital to a modern, skills-based economy. Palestine could also capitalize on the good will and proximity of the Arab world; if it built efficient capital markets in a politically stable setting, Palestine could become a financial and commercial-services hub for the Arab East. It could also take advantage of historically low interest rates and the ability to leverage bilateral and multilateral guarantees to develop infrastructure in water, alternative energy, environmental protection, tourism, transportation and communications.

Consider, too, that the area has favorable conditions for developing high-value agriculture and agricultural technologies – fruits, vegetables, animals and high-value growing practices. Technology transfers from Israel, a country that has figured out how to grow food and fiber in unlikely places (in an environment similar to those found in Palestinian areas), could sharply improve Palestinian agricultural productivity. Currently, the average agricultural yield in the Palestinian Authority is just half of that in Jordan and 43 percent of that in Israel. The information and communications technologies sector, which has been a bright spot over the past decade, can continue to develop as a key driver of economic growth.

It's important here to emphasize that developing strong economic ties between a new Palestinian state and Arab countries would serve the interests of the Israelis as well as the Palestinians, reducing the pressure on Israel to go out of its way to nurture the development of the latter. Arab states, along with the United States and Europe, could also offer preferential trade and tariff agreements to kick-start employment and production in special economic zones, as they have done in Jordan and Egypt over the past decade.

Tourism agreements between Israel and Palestine that make it convenient to visit both Israel and Arab sites in single trips could also play an important role in driving economic development. Tourism, especially high-value-added tourism, is, after all, a labor-intensive industry with great potential for absorbing the large and rapidly growing numbers of unemployed Palestinians.

Finally, industrial development inside Palestinian areas, including state-of-the-art industrial parks, incubators for tech startups and accelerators supported by international businesses, would facilitate technology transfers. Ideally, much of the effort would focus on intermediate and finished products with export potential.

Looking Inward: Local Investment in Economic Development

One approach to locally led economic development harks back to the investment-leveraged-by-aid model. The idea is to employ donor funds more effectively by using them to shelter private projects from the systemic risks inherent in operating in the region. Specifically, donors could provide credit enhancement and risk insurance, as well as underwriting the planning phase for private investment in a variety of important economic developments:

Water. A handful of specific river basin projects would have an immediate impact on living standards in Palestinian cities and villages, as well as provide water for higher productivity agriculture and industry.

Energy. Natural gas production, electricity cogeneration and alternative fuels production (solar, biomass renewables) would reduce the need to spend scarce foreign exchange on imports and in some cases have the potential to be highly profitable. These projects would also generate stable, predictable revenues that could be used to leverage added private fund-raising.

Trade, tourism and transportation. Here, we would include regional inter-urban rail, port and, eventually, air facilities, as well as destination tourism at religious, archeological and recreational sites. It could be time to revisit the RAND Corporation's attempt in the Arc Project to plan infrastructure to support commercial and residential development in an increasingly urbanized country – and offer viable alternatives to continuing life in refugee camps.

Housing construction and finance. The expansion of markets for mortgages would stimulate homeownership and urban revitalization, as well as invigorate focus on green buildings and sustainable housing in this fragile semi-arid environment.

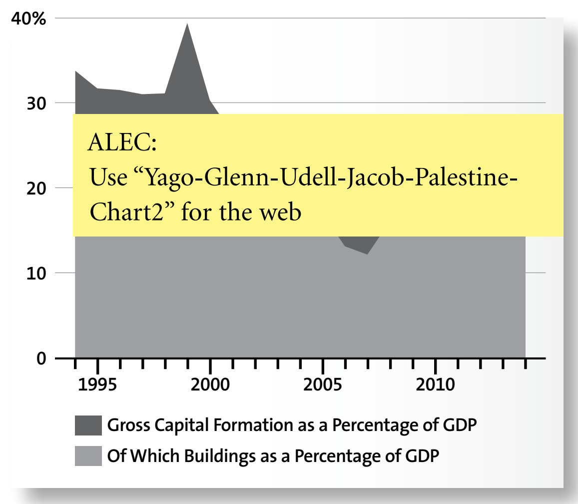
Looking Up: Capital Ideas

Even carefully refined projects designed to harvest the low-hanging fruit first will not get off the ground unless the drought of private-sector credit in the Palestinian territories ends. Though Palestinian banks have become more sophisticated in terms of underwriting standards and post-loan monitoring, they still lack tools needed to reach the scale of private sector credit available in other developing countries in the region.

By the same token, there has been little effort to employ the many successful models for raising investment funds in high-risk environments. Among the possibilities: partnerships with multinationals for private concessionaires to run public facilities, privatization of public utilities ranging from power generation and distribution to border-logistics management, and venture capital funds for targeted growth sectors like food processing.

Establishing a strong legal and regulatory infrastructure for the Palestinian Authority's financial markets is, of course, a prerequisite for leveraging donor funds for project finance. And there is much to be done – for example, fewer than 50 companies are listed on the Palestinian Securities Exchange. Creating diverse securities that could be traded at low cost, possibly with enhanced credit via donor funding, would increase the total pool of cash for development projects. Note, moreover, that investors in Israel, Palestine and Jordan have generally responded favorably during periods of stable commerce.

CAPITAL FORMATION IN THE WEST BANK AND GAZA



SOURCE: Sebastian Welisiejko, "The Palestinian Economy," presentation at Milken Innovation Center, Jerusalem Institute, August 2015; Palestinian Central Bureau of Statistics Data

THE WINDOW OF OPPORTUNITY

Despite good intentions, donor-driven development in the context of constant political tension offers little evidence of progress. But, as we argued a decade ago, identifying and supporting specific projects provides a way to take concrete steps toward cooperation and stability. Success lies in the pragmatic use of the economists' toolbox to facilitate growth, plus an understanding that the Palestinian economy must be able to stay afloat without tethers to Israel. Ultimately, the past two decades have proved that only by structuring shared economic interests will a political solution become feasible. And when the history of this long, grinding phase of the Israeli-Palestinian conflict is written, the accounts could emphasize how economic strategy, financial leverage and the creation of jobs and income help manage disruptive forces in the effort to form a new state.

LETTER FROM TÔHOKU

BY RAMONA BAJEMA

March in Japan is the time for graduation ceremonies and end-of-year accounts. It is a time of flux, waiting for full-blown spring, with the cherry blossoms still two months away. ... rific memories.

ALEC:
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Caption for Home page is: "The sun also sets"
Main topic: Asia
Other topics: Economic Development

On March ... disas- earthquake trigg... area waves along 30... erms. towns were wiped away in minutes. And the subsequent failure at the Daiichi nuclear plant in Fukushima forced the evacuation of hundreds of thousands otherwise safe from the natural disaster. The catastrophe killed almost 20,000 and forced the relocation of half a million survivors. It was by far the costliest natural disaster in material terms in world history.

The Tôhoku region is part of Japan's rural hinterlands, with twice the area of Kanto (home to Tokyo and Yokohama) but just one-fifth as many residents. And though Tôhoku's population (now nine million) had been decreasing before the disaster, the erasure of coastal towns and contamination of others has sped up the process.

As expensive as the disaster has been for the Japanese government and the owner of the Daiichi plant, the Tokyo Electric Company (also known as Tepco), Tôhoku's economy wasn't large to begin with. It generated only about 6 percent of Japan's total GDP in

An ambitious reconstruction does, however, provide an opportunity for fiscal stimu-

RAMONA BAJEMA, who holds a PhD in modern Japanese history from Columbia University, managed the Americares recovery program in Tôhoku from 2011 to 2015.

lus, which has long served Japanese governments' objectives in the countryside. Until recently, Tôhoku was a stronghold of the Liberal Democratic Party, which still claims a disproportionate share of patronage. Instead of building more bridges to nowhere to provide local jobs and profits for construction companies, post-disaster projects have been recast as "recovery highways," and their budgets have been approved without debate.

I moved to Sendai, Tôhoku's largest city and its economic and political capital, in June 2011 to run the tsunami recovery effort of the private nonprofit Americares. While newspapers around the world printed stories about the survivors who stood in orderly lines with blank expressions, I saw a less stoic side of the Japanese. Men in the small city of Minami-Soma sobbed when they talked about their horses that drowned. Others trembled when describing how they left their dairy cows to starve when radiation contamination prevented them from returning to their farms. Six years later, relatives and rescue teams continue to search for the remains of the nearly 3,000 people still categorized as "missing." Suicide rates, alcoholism, domestic violence and clinical depression have risen at alarming rates since 2011.

Today, the fear of decline permeates Tôhoku. While Sendai has experienced a population boom as construction companies and administrators rushed to participate in the reconstruction, the region's overall population has dropped by 6.7 percent. It is likely that some areas have even fewer residents than official numbers show because many have left without re-registering in their new

GIANNI GIOSUE/ANZENBERGER/REDUX

IKURU KUWAJIMA/LUZPHOTO/REDUX

locations in hopes of returning later.

Some public intellectuals – such as Akemi Yamauchi of Taisho University – have exhorted locals to focus on quality-of-life issues rather than population decline, arguing that contracting markets matter less in the long run than preserving local culture and traditions. When I echoed that sentiment to Japanese friends, they responded with consternation, although they thanked me for "loving Japan."

VERY BIG NUMBERS

I returned to Tôhoku earlier this year to see for myself what progress had been made in the region's recovery. I drove from the town of Soma (in Fukushima Prefecture) north some 140 miles along the coast to Ofunato. When I first arrived in 2011, mountains of debris, partially destroyed homes and remnants of boats (some stuck on rooftops) greeted me. Now, the route is the axis of what must be the largest construction project on record. Driving through the Fukushima countryside, you see giant piles of stacked black plastic bags full of contaminated soil. These bags are on their way to "temporary" storage sites near the decommissioned plant (a permanent site has not been agreed upon).

The Japanese government has thus far spent $226 billion on recovery and reconstruction, an amount that does not include financial support paid by Tepco to those affected by radiation contamination nor the Daiichi plant's ongoing cleanup. And these payments may in the end nearly double the total outlay. By comparison, the cost of Hurricane Katrina, which flooded New Orleans and destroyed swaths of the Gulf Coast, topped out around $110 billion.

A TASK FOR SISYPHUS

My road trip along the coast stayed well out of the area that absorbed the worst of the radiation blown inland by prevailing winds. I grew accustomed to highways jammed with dump trucks moving earth from one location to the next. But I was able to ditch my car north of Sendai, thanks to the reopening of the Joban rail line that connects Sendai with Fukushima Prefecture's northern coastal cities. The rail line is (and was) more than a matter of convenience, though, as it provides easy access to the commercial center of the region.

In spite of this "symbol of hope," as Prime Minister Shinzo Abe described the railway at its reopening, anxiety still plagues Fukushima's residents. A recent report showed that radiation levels deep within the destroyed reactors remain at levels that could kill a person in a minute and destroy a robot within two hours. Inevitably, then, the last phase of the cleanup will be very slow. In any case, radiation might not be the biggest threat to residents' health. As in Chernobyl, the premature deaths from other causes (including suicide) outnumber those that were directly caused by the events of March 11.

Nonetheless, residents' economic concerns apparently far outweigh their fears of ill health. People are conscious of the threat from radiation, but are resigned. What Fukushima residents feel more directly is the impact the catastrophe has had on the Fukushima "brand."

Although the government is trying to repackage Fukushima as safe on television commercials and train advertisements that show popular actors eating Fukushima peaches, the radiation-spooked Japanese public largely remains unwilling to ingest Fukushima products or sightsee in the area. I heard anecdotes about farmers giving gifts of rice to relatives in Tokyo, later to find out that it had been tossed. Another variation on the theme: eligible young women from Fukushima feel they must conceal their hometown identity because their dates might think they won't be able to bear healthy children.

The word "Fukushima" printed on a food product means that consumer demand will be nil for the foreseeable future. Hence, Japan's postwar "rice basket" must find another use for the land. Massive amounts of former farmland have been set aside for renewable energy production. Still, it would be (yet another) monumental task to cover all the former rice paddies with solar panels.

Some effort has been made to convert local agriculture to nonfood products. One little farm near the town of Kawamata specializes in a bloom that is popular at Tokyo's funerals. The Fukushima Organic Cotton Project sold T-shirts at Tokyo's Mitsukoshi department store last year. And project organizers celebrated how the store advertised them simply as "Fukushima cotton" rather than as disaster relief charity.

But the gloom persists. Several towns that had previously been designated "no entry" were scheduled to reopen in March 2017 after a $35 billion cleanup. It is unclear, though, whether the massive cleanup will be effective in eliminating the long-term risks of radiation exposure – and, equally to the point, whether people will believe that it was effective. Mountainsides, for example, could not be bulldozed, and rainfall will wash unspecified amounts of contaminated soil down to the inhabited areas.

The cleanup did create a welcome bubble of commerce. According to the owner of a roadside restaurant, the greatest change since we met years ago has been the lunchtime onslaught of construction workers, engineers, administrators and managers who came to the area to work. The crowd, whom he called the "unknown faces," was tapering off, though – the bubble is deflating.

A young man who has opened a beauty salon in Soma, which is on the coast south of Sendai, hoped that his livelihood would not be affected by the undertow of departures. After all, his business, like that of a dentist I spoke to, catered to locals. He returned to the coast out of obligation – he knew Soma was struggling to keep its young people and wanted his children to share his upbringing.

Was he nervous about radiation? Not really. As with most of Fukushima's residents, government funding was by far the bigger concern.

Tokyo drew a line around areas that were determined to be uninhabitable, where residents would be fully compensated. People who move back to surrounding "decontaminated" areas continue to get support. Residents of Minami-Soma, Futaba, Namie and other towns close to the Daiichi plant have received monthly allowances that include $1,000 for "mental suffering." But residents in places like Soma, a few miles outside the forced evacuation circle, haven't gotten cash from Tepco – and resent those who have. ("Did you see that guy from Minami-Soma the other day? He's driving a Mercedes-Benz.")

There is little incentive for young families to return to towns that are largely populated by the elderly and have no operating schools.

After six years and mounting cleanup costs at the plant, funds are running out. There are 48,000 evacuees living outside Fukushima and 41,000 who relocated to safer areas within the prefecture. Many have not succeeded in finding affordable housing, locating new jobs or negotiating their family logistics. Yet Tokyo declared that, as of March 2017, voluntary evacuees would no longer receive government funds.

In part, the cutoff is intended to encourage people to return to Fukushima, since the government is insisting that cleanup efforts have made the area safe. However, there is little incentive for young families to return to towns that are largely populated by the elderly and have no operating schools.

Frustrations with the rate of recovery led to a political backlash in Tôhoku. In the summer of 2016, the ruling Liberal Democratic Party lost five of its six upper house seats in the region. Voters further objected to the expected reduction in protection for uncom-

Q. SAKAMAKI/REDUX

petitive domestic agriculture that's part of the Trans-Pacific Partnership trade deal signed by Abe (and thereafter abandoned by President Trump). "Stop TPP!" signs dot the landscape.

One ray of high-tech hope is the idea of transforming Fukushima into a laboratory for renewable energy funded by public-private investment. In January, to take one example, Toshiba, Tôhoku Electric and the Iwatani Corporation announced a feasibility study to build the world's largest facility for synthesizing hydrogen gas to power fuel-cell vehicles. Tôhoku's own commitment to renewable energy (and rejection of nuclear power) is implicit in the proliferation of solar panels on rooftops throughout the region.

Traveling north from Fukushima along Miyagi Prefecture's coast, I reflected on the changes to the landscape. Where houses, post offices, gas stations, supermarkets and schools once stood, the land is barren, with only concrete foundations marking what used to be neighborhoods. Near Yuriage, a particularly devastated area south of Sendai, I noticed that a few factories dot what had been an empty landscape. Much of Miyagi's southern coastline has been designated as too dangerous for housing, but some areas will host industrial sections, along with sterile parkland with lonely benches and fields of solar panels.

FINDING HOUSING FOR THOUSANDS

Some 470,000 were evacuated to shelters scattered around the country. Four months after the disaster, 330,000 of them had moved into subsidized apartments or small, boxlike houses hastily erected by the government. Roughly half are still there, waiting for public housing or the go-ahead to build their own.

While they wait, though, construction costs have soared – in part, because of demand created by the 2020 Tokyo Olympics. Japan's public broadcasting company, NHK, reported the case of an 83-year-old man who had intended to rebuild his house after the land under it was elevated by some 60 feet, safely beyond the reach of the next tsunami. He now believes that it would be a waste of his limited savings to rebuild.

Scattered across the landscape are plots that are truly ready to build on. However, land deeds are often hard to find in rural Japan – or simply do not exist because the land passed on through generations without written record. The problem here is even worse since a lot of official paperwork washed away in the tsunami. Municipalities have scrambled to identify who owns what, and whether it is available for purchase. But their scramble might be too late: current population trends suggest that the demand won't be there by the time property rights are clarified.

In the meantime, backhoes move mountains and pat, pat, pat down mounds of red earth to accommodate the diminished population. The town of Rikuzentakata built a two-mile-long conveyer belt system costing over $100 million to carry some 40,000 tons of soil and gravel a day to create a high-ground residential area for 61 apartments. In Ishinomaki, public housing has been built on top of elevated land near an area that was inundated by the tsunami. But the apartments are proving to be an especially hard sell because people don't want to live in an area where so many drowned in the tsunami.

One consequence of the housing gridlock

was an epidemic of depression among the displaced – especially the elderly, the poor and the sick – who are stuck in temporary housing. Early on, support groups of various stripes offered both recreation and the myriad services otherwise provided by friends, family and neighbors in tight-knit rural communities. *Kodokushi*, dying alone from social neglect or self-neglect, was a particular concern.

Outside support groups, public and private, have largely stopped coming. But this withdrawal of psychosocial services has been partly offset by an assertion of community identity, with residents stepping in to care for their neighbors. In the same vein, local groups used the disaster to bring attention to social needs that predated the tsunami. For example, when multiple generations routinely lived under the same roof, the older women took responsibility for infant care. That piece of the social fabric has been fraying for years. But the disaster has catalyzed female leaders to organize and provide a host of services for isolated new mothers.

I used to gaze at the surf as I drove along the coast road (Route 45), thinking about how cruel the ocean had been on March 11, yet how vital it was to the region's identity and economy. Driving the road this winter, concrete walls largely blocked the view of the sea.

Before the government started communal reconstruction, it developed a plan to build a seawall as a first defense against future inundations. The wall was to more or less run the 250 miles of coastline at greatest risk, at a cost exceeding $8 billion. For example, one portion guarding the fishing town of Kesennuma would be almost 50 feet high and 30 feet thick.

No environmental impact report was filed before construction at any point along the seawall. Although many residents voiced objections, believing that clearly defined escape routes would be sufficient in future disasters, landowners where the wall was to be built received inflated sums and allowed the project to proceed. And in a narrative familiar to Japanese citizens over the decades, construction companies gorged on government contracts even as allegations of price collusion clouded the process.

Prime Minister Abe's wife, Akie, visited Rikuzentakata and engaged in informal discussions with evacuees about plans for the wall. These conversations prompted her to host a 2014 conference in Sendai (miles from the coastline) with the title "What Do You Think about the Monster Seawall?" According to a survey at the event, 84 percent of respondents felt that the plan had been too rushed and required further discussion. By that time, however, the protest was moot; construction was well under way.

When I rounded a familiar bend on Route 45, I saw Rikuzentakata's seawall for the first time, the height of a four-story building. Some residents described the wall as being "prisonlike," though the city intends to plant lines of pine trees to camouflage it. When asked about the wall, residents seem resigned: "It's built now. There is nothing we can do about it." Although their livelihood is most threatened by the concrete, fishermen have vowed to work around it and continue to operate their mollusk and seaweed farms.

The government is moving mountains and building concrete monuments, but economic benefits are not immediately obvious.

AFLO CO. LTD./ALAMY

The government is moving mountains and building concrete monuments, but economic benefits are not immediately obvious. The government reported in the summer of 2016 that 80 percent of businesses affected by the disaster (setting aside those in Fukushima's exclusion zone) were up and walking. Directly after the tsunami, the economists Anil Kashyap and Takeo Hoshi warned against revivifying "zombie" businesses that had been failing long before the disaster. But from the government's perspective, delays to review plans before releasing funds would have appeared insensitive. Nevertheless, of the companies that received recovery subsidies, less than half are generating sales at predisaster levels.

MOVING FORWARD

Tourism was long a mainstay of the Tôhoku economy. Yet, while Japan is experiencing a foreign tourism boom, particularly from China, few visitors are venturing into the region. Major efforts are now under way to draw tourists to Tôhoku. Sendai will host the 2020 Olympics' soccer events, and Kamaishi, a hard-hit industrial town in Iwate Prefecture, will host the 2019 Rugby World Cup. After the cheering dies down, though, the coastline's natural beauty should be Tôhoku's sustaining attraction. And far too much of it is now hidden behind thousands of tons of concrete.

I believe that the region's hopes for a comeback turn less on splashy government-funded projects than on individual savvy and initiative. Consider Emi Takahashi, director of a day care center for the elderly, who (rightly) fears too many resources will be spent on facilities for aging baby boomers that will all too soon become white elephants. She has started a program to train elderly husbands who lack confidence in their household skills to care for wives suffering from dementia so they can stay home rather than be institutionalized.

A variety of grassroots organizations have also emerged with their own visions for the region's reconstruction. Next Commons Lab is, in the words of its founder, Atsushi Hayashi, a "post-capitalist" model for cooperative business enterprise. While idealistic, the group has had some success in revitalizing small, seemingly unsustainable for-profit enterprises elsewhere in rural Japan. And with Minami-Sanriku in Miyagi Prefecture as its entry point, Next Commons Lab is expecting to begin operations this summer.

The list goes on. AP Bank, a nonprofit that funds businesses with an eye on environmental and social impact, has opened an office in Ishinomaki, the site of the largest number of tsunami casualties. The group is sponsoring an art festival this summer that will feature national and international avant-garde artists. More Trees, a group founded by the musician and activist Ryuichi Sakamoto and the architect Kengo Kuma, is also seeking opportunities to maximize the resource potential of Tôhoku. Kuma, who won the bid to design the Tokyo Olympic Stadium, has designed a shopping district in Minami-Sanriku to be filled with local stores now stuck in prefab buildings.

With the advantage of hindsight, it's plain that the inclination to roll back the clock to the pre-tsunami era in Tôhoku is misguided. The region, like most of the rest of rural Japan, was in economic and social distress long before the waves hit. And no amount of earth moving and concrete pouring is going to fix what ails.

What Tôhoku needs most now is help in adapting to rapid economic and demographic change accelerated by the disaster, buffering the dislocation at the grass roots. And that, alas, is not an easy sell in a contemporary Japan that's struggling with all manner of unwanted change.

Coming Together

In December, in one of the few instances of bipartisanship in 2016, President Obama signed into law the 21st Century Cures Act. The legislation provides $4.8 billion of new funding for the National Institutes of Health, along with additional funds for the Food and Drug Administration and a comprehensive suite of policy provisions to strengthen the biomedical innovation system. FasterCures, the Institute's D.C.-based center dedicated to accelerating medical research, worked with leaders in Congress, the NIH and the FDA, reaching out to stakeholders throughout the medical research system to help translate the best ideas into law.

"This landmark legislation will accelerate cures for many life-threatening diseases and help advance precision medicine," explained Institute chairman Mike Milken. "It ensures patient-focused drug development, adds rigor to clinical trials, expands compassionate use of new drugs by dying patients, speeds the review of vaccines, addresses antibiotic resistance, responds to the opioid crisis and strengthens the research infrastructure."

Where to Age Gracefully

In March, the Institute released the latest update of one of its widely watched indexes. *Best Cities for Successful Aging* ranks 381 U.S. metropolitan areas on how well they serve the needs of America's rapidly growing population of older adults. The index is not another guide to the best places to retire. Rather, it provides 83 indicators that determine overall quality of life for seniors. Among the key factors often ignored in assaying the attractions of metros: employment opportunities and level of community engagement.

"Cities are on the front lines of the largest demographic shift in history," says Paul Irving, executive director of the Institute's Center for the Future of Aging, which released the report. "Older adults increasingly seek lifelong engagement, and expect their communities to support their changing needs."

The top seven ranked towns: Provo (Utah), Madison (Wisconsin), Durham-Chapel Hill, Salt Lake City, Des Moines, Austin, and Omaha. Read the Institute's report in its entirety at successfulaging.milkeninstitute.org.

Financial Deregulation in the Time of Trump

With a new president in the White House, the financial community is assessing the prospects for significant changes – even a complete overhaul – of financial regulation. In a recent paper, "Financial Deregulation: Repeal or Adjust?" Institute researchers Claude Lopez and Elham Saeidinezhad provide a timely overview of the landscape of agencies that compose the U.S. financial regulatory structure. Available on the Institute website, the report is an eye-opener for anyone trying to handicap the regulatory horserace in D.C.

TALKING EYES MEDIA

Cheap Beef?

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comparable World Bank conversion factor for 2015 and the Big Mac Index for the middle of that same year (2015). No matter how you slice it, it seems the dollar is overvalued. Or to put it another way, for those of us paid in dollars, the rest of the world is a pretty cheap place to buy Big Macs (and a whole lot else).

ALEC:
Headline is "Cheap Beef?"
Caption for Home page is: "South Africa is a bargain."
Main topic: Indexes and rankings
Other topics: Monetary Policy
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	BIG MAC JAN 2017 (OVER/ UNDERVALUED %)	BIG MAC JULY 2015 (OVER/ UNDERVALUED %)	WORLD BANK CONVERSION 2015 (OVER/ UNDERVALUED %)
Brazil	+1%	−11%	−40%
Canada	−11	−5	0
China	−44	−43	−40
France	−15	−11	−10
Germany	−22	−11	−10
India	−51	−61	−70
Israel	−13	−3	0
Japan	−36	−38	−10
Mexico	−56	−35	−50
Norway	+12	+18	+20
Russia	−58	−61	−60
Saudi Arabia	−37	−33	−60
South Africa	−63	−56	−60
Switzerland	+26	+42	+30
Vietnam	−48	−43	−70

SOURCES: *The Economist*, World Bank