

George J. Stigler Center
for the Study of the Economy and the State

2005-06 Annual Report



The University of Chicago Graduate School of Business



George J. Stigler Center

for the Study of the Economy and the State



George J. Stigler founded the Center for the Study of the Economy and the State at the University of Chicago in 1977. It has from the beginning been a joint enterprise of economists and legal scholars at the Graduate School of Business, Department of Economics, and the Law School of the University of Chicago. The center was renamed in Stigler's memory after his death in 1991.

The Stigler Center is dedicated to the study of the effects of political life on economic life and the reciprocal effects of economic life on political life. That is not a very restrictive mandate, since there are few areas of our lives where neither economics nor the state intrudes. To carry out its mission, the Stigler Center supports research of faculty at the University of Chicago and of visitors from other academic institutions. The center publishes a Working Paper series and promotes the dissemination of this research to a wider audience via conferences and lectures.

The Stigler Center contributes importantly to the continuity and growth of "Chicago Economics," which is known worldwide for two attributes:

- A tough-minded professional style that views economic theory not as an end but as a tool to assist in understanding the real world
- A lively appreciation for the working of private markets

The Stigler Center is extremely grateful for the generous support provided by Raph Appadoo, '82; Lynde and Harry Bradley Foundation; Pfizer Inc.; Sarah Scaife Foundation; and Searle Freedom Trust

For more information visit us at www.stiglercenter.org

Edward A. Snyder Richard Leftwich
Interim Director *Interim Research Director*

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From the Interim Director



Edward A. Snyder
Dean and Interim Director

The Stigler Center's mission is to support economic research about the interaction between the private economy and the state. This Annual Report summarizes the work of the center's research community for the 2005-06 academic year; the breadth of topics covered is testimony to both the pervasiveness of public policy concerns in our lives and to the ingenuity of Chicago economists in applying economics to them.

The essence of the research conducted at the Stigler Center is the application of Chicago-style economic analysis to issues confronting economic policy makers at all levels of government. This Chicago style of analysis has several hallmarks:

- an interest in applying economic theory to better understand real-world developments
- a deep appreciation of the ability of private markets to allocate scarce resources efficiently
- an understanding of the contractual and regulatory infrastructure necessary to support those markets
- an effort to verify theoretical predictions of behavior through a careful analysis of data and evidence.

Recent Developments at the Stigler Center

This coming year marks an unexpected transition for the center, with former director Randall S. Kroszner appointed a Governor of the Federal Reserve Board. Randy joins fellow Stigler Center scholar Raghuram Rajan in Washington, where Raghu continues as Economic Counselor and Director of Research at the International Monetary Fund. We will miss Randy's tireless efforts on behalf of the Stigler Center, but we are proud of his willingness to serve our nation in such an important capacity. Over the coming months, Research Director Richard Leftwich and I will lead the center on an interim basis. Our most important task will be filling the director's position.

Highlights of our Scholars' Current Research

Stigler Center research on the interaction between the economy and the state most often examines the incentives facing an individual agent and that agent's resulting behavior—be it a firm contemplating replacing its CEO, a household deciding how much television its children should watch, or a judge considering a defendant's personal characteristics when choosing a sentence. This focus on individual behavior certainly does not limit the range of analysis undertaken at the center. For example, researchers have examined the reform of the Chinese banking system, the regulation of electrical utility pricing, and affirmative action.

Stigler Center researchers are especially adept at applying the insights of economic analysis to important areas of concern to policy makers in novel ways. Topics that our researchers have investigated this year include the relationship between culture and economic growth, corruption in the licensing of Indian drivers, and the costs and benefits of a policy of containment versus waging war in Iraq. Reading the descriptions of our researchers' activities this year will give you a better sense of the quality and importance of the center's work.

An impressive group of researchers are affiliated with the Stigler Center, including Nobel laureate Gary Becker, 2005 MacArthur "Genius Grant" winner Kevin Murphy, and Marianne Bertrand, winner of the foremost honor given to young female economists.

Outreach Activities

The Stigler Center also promotes discussion of the issues on our research agenda in both general public forums as well as before academic audiences. The center organized a number of important events during the year, including:

- A panel discussion between former New York Stock Exchange Chairman John Reed and current Chicago Mercantile Exchange CEO Craig Donohue on the challenges and opportunities facing the financial exchanges
- A Chicago lecture by Czech President Vaclav Klaus that warned of the dangers in the evolution of the European Union
- A session on the competing interests of state and federal bank regulators co-sponsored with the Federal Reserve Bank of Chicago
- A presentation by Allan Meltzer highlighting insights from the draft of the second volume of his seminal *History of the Federal Reserve*.

Our accomplishments could not have occurred without the generosity of our supporters. The Stigler Center is extremely grateful for the generous support provided by Raph Appadoo, '82; Lynde and Harry Bradley Foundation; Pfizer Inc.; Sarah Scaife Foundation; and Searle Freedom Trust.

Sincerely,



Edward A. Snyder
Interim Director

OUTREACH ACTIVITIES

Stigler Center Outreach Activities

The Stigler Center organizes and helps sponsor a variety of conferences and lectures to reach a wider audience and to foster communication between academic researchers and government policymakers. Over the past several years, our outreach efforts have intensified, thanks to the interest and generosity of our supporters. Highlights from this year's activities are listed below.

Changes at the Exchanges

November 29, 2005

The Stigler Center's longstanding interest in corporate governance was given a practical application when center director Randall S. Kroszner hosted a discussion between former New York Stock Exchange Chairman John Reed and current Chicago Mercantile Exchange CEO Craig Donohue. Both the NYSE and CME have undergone sweeping changes in the past five years. Under Reed's leadership, the NYSE addressed a crisis of credibility, increased transparency, and took the first steps toward becoming a publicly traded company. Donohue led an overhaul of the CME's governance, moving from an "owner-operated mentality" to a public company environment. Both men shared practical lessons they learned in these transformations and drew lessons for future developments and challenges facing the exchanges.

With regard to governance, Reed and Donohue described the different approaches taken by the NYSE and CME. Faced with credibility issues brought about by the pay received by Richard Grasso, as well as pending investigations of floor brokers and specialists, Reed felt that the NYSE had to pursue an aggressive policy, sharply reducing the size of the board and mandating independent directors. At the same time, a Board of Executives was created to provide the Board of

Directors with the expertise and engagement of people working on the floor. According to Donohue, the CME was not facing a crisis and could pursue a more tempered approach. The new board structure includes exchange members without creating conflicts of interest.

The discussion also highlighted the different regulatory environments faced by a securities exchange (NYSE) and by a futures exchange (CME). Donohue emphasized that the CME's regulators were quite receptive to the transition to a publicly traded company and to the growth in electronic trading. For the NYSE, the Securities Act of 1934 complicated the transition to a modern governance structure. Looking forward, both Reed and Donohue see a hybrid system of trading that involves both electronic and floor trading. In terms of trading arrangements, one size does not fit all, especially when trading shares in companies of varying sizes or competing against futures exchanges located in outside the United States. The panel received press coverage in both *Business Week* and the *Wall Street Journal*.

Michael Moskow, President and CEO, Federal Reserve Bank of Chicago

March 7, 2006

The Stigler Center helped sponsor Michael Moskow's visit to the Graduate



Randall S. Kroszner (left) hosts a spirited discussion with John Reed (center) and Craig Donohue during Changes at the Exchanges.

Michael Moskow, conversing with a second-year student at the Distinguished Speaker Series.

Czech Republic president Vaclav Klaus visited the Hyde Park Center in April as part of the Distinguished Speaker Series.



School of Business as part of the school's Distinguished Speaker Series. The Federal Reserve is perhaps the most important governmental entity that influences economic activity—a central player in the interaction of the economy and the state. Moskow emphasized that the Fed's mandate for price stability requires careful attention to inflation expectations. According to Moskow, "In the long term, inflation expectations are a function first and foremost of Fed credibility." Credibility can create a virtuous feedback mechanism. "Does the public believe that we will act to fulfill our commitment to achieving price stability? If this belief is widely held, then long-run inflationary expectations will be well anchored." Moskow called for more study of whether the Fed should adopt a numerical inflation target and welcomed the appointment of new Fed chairman Ben Bernanke. Regarding current conditions, he stated that inflation is near the upper limit of his comfort zone, while the main risks to the economic outlook are rising energy prices and a potentially overheated housing market.

Allan Meltzer, Renowned Monetary Economist and Economic Historian

April 12, 2006

In cooperation with the Center for Population Economics, the Stigler Center co-hosted Allan Meltzer's visit to Chicago's Hyde Park campus. Meltzer is the Allan H. Meltzer University Professor of Political Economy at Carnegie Mellon University and author of the widely acclaimed *A History of the Federal Reserve*. He presented highlights from the draft of the second volume of the

history, drawing lessons from the dramatic rise and fall of inflation in the United States from the mid 1960s through the early 1980s.

Meltzer's second volume attempts to explain what triggered the rise in inflation in the mid 1960s, why it continued for 15 years, what brought about its decline in the mid 1980s, and why it has not returned. He sees errors in economic analysis as the main contributor to the run-up in inflation. In particular, Meltzer notes that the Federal Reserve economists paid too little attention to money growth. Once inflation set in, it was allowed to continue as the public, Congress, several administrations, and the Federal Reserve were unwilling to permit unemployment to increase long enough to end the inflation. Echoing Michael Moskow's presentation a month before, Meltzer emphasized that markets soon built this behavior into their inflation expectations, making it more difficult for a series of temporary anti-inflation policies to succeed. Inflation ended only when public attitudes began to change. Eventually, the public recognized inflation as a large problem, which eased political pressures and allowed the Federal Reserve to reduce inflation in the early 1980s. Since that time, the Federal Reserve has maintained a vigilant attitude toward inflation, tightening monetary policy quickly enough to counteract price pressures, thereby preventing the return of inflation.

Vaclav Klaus, President of the Czech Republic

April 26, 2006

The Stigler Center also helped sponsor the visit of Vaclav Klaus to the Graduate School of Business as part of the school's Distinguished Speaker

Series. This is the second time that the center has helped to sponsor a visit by Klaus—he presented the second Stigler Memorial Lecture in May 1998. In his talk this year, Klaus commented on the two main developments in the Czech Republic over the past 15 years: the transition from communism to capitalism and the participation of the Republic in European integration. According to Klaus, the Velvet Revolution against communism has given the Republic a fully functional political system and an economic system based on private ownership. Over the same period, the Republic also has been adjusting to the process of European unification. He criticized the prevailing American view in favor of integration as naive, unstructured, and lacking analytical content. “I’m afraid that the Americans do not see the EU’s accelerating drive towards the social democratic—and I would say more social than democratic—European super-state,” said Klaus. The desire to achieve European peace through unification is leading to the construction of institutions that restrain freedom, democracy, and entrepreneurship and create economic inefficiencies. The European Union is moving away from free markets in its move towards regulation and standardization. He also warned that integration would not diminish anti-American feelings in Europe. He argued that the costs of unification are substantial, especially for the Czech Republic that is in a “vulnerable, post-transition stage.”

Federal Preemption of State Banking Regulation

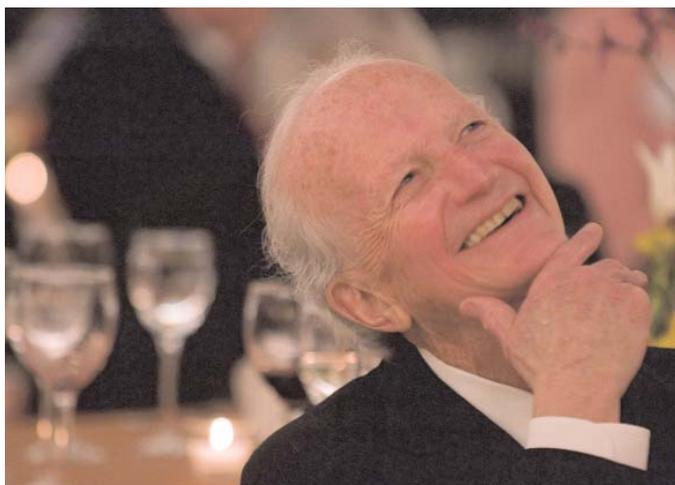
May 19, 2006

Together with the Federal Reserve Bank of Chicago, the Stigler Center sponsored a panel on the relationship

between state and federal bank regulation. This issue has come to the forefront with the recent disagreement between the Office of the Comptroller of the Currency (OCC) and the New York State Attorney General Office on access to mortgage lending records of nationally chartered banks. The OCC, supported by the courts, ruled that national banks did not have to grant access to their records. The conference of state bank supervisors argues that the courts’ support of the OCC ruling has encouraged banks to convert to national charters and is posing a threat to the existing dual banking system. The Federal Deposit Insurance Corporation has held hearings on how to put state-chartered banks on equal footing.

To evaluate and better understand the issues involved in the preemption debate, the session assembled a panel of experts that included Phillip Strahan, Associate Professor of Finance at the Carroll School of Management at Boston College; Arthur Murton, Director of the Division of Insurance and Research at the FDIC; and James Roselle, Associate General Counsel of the Northern Trust Corporation. These panelists considered the economic arguments for and against a dual banking system, including the effects of regulatory competition, barriers to entry, and the implications of preemption for the future of the dual banking system and the structure of federal regulation of banks and bank holding companies. While there was significant debate on the legal issues and extent of the OCC’s preemption power and rights, the economic arguments concerning the social benefits resulting from broader geographic expansion were quite convincing. The session is one example of the Stigler Center’s efforts to open the lines of communication between the research and

RESEARCH SUMMARIES



Gary Becker

University Professor
Department of Economics
Department of Sociology
Graduate School of Business

The Economic Theory of Illegal Goods: The Case Of Drugs

The War on Drugs has been fought by police, the FBI, the CIA, the DEA, the military, and military and police forces of other nations. Why has the War on Drugs been so difficult to win? Stigler Center researchers Gary Becker and Kevin Murphy, along with Michael Grossman, answer this question using the tools of economic analysis. They show that the sensitivity of the demand for drugs to a change in drug prices is crucial to understanding the effects of attempts to punish producers and users of the drug. Becker and his colleagues compare consumption and prices when a drug is legal and taxed with consumption and prices when the drug is illegal. They show that taxing a drug that has been legalized could cause a greater reduction in output and increase in price than would optimal enforcement in the case where the drug remains illegal. Fighting a war on drugs by legalizing drug use and taxing consumption may be more effective than continuing to prohibit the use of drugs. And yet, societies almost always choose to use criminal punishment rather than legalization coupled with high taxes to fight the War on Drugs. Becker and his colleagues point out that high-income groups support making drugs illegal and punishing suppliers and consumers by imprisonment, since imprisonment is more costly to higher income persons and is therefore more effective in reducing their consumption. Thus, even if low, middle, and higher income parents have the same desire to discourage drug use by their children, the greater political influence of high income groups explains why drugs remain illegal rather than legal.

Other Projects in 2005–06

Evolutionary Efficiency and Happiness



Marianne Bertrand

Fred G. Steingraber/A.T. Kearney
Professor of Economics
Graduate School of Business

Do Judges Vary in Their Treatment of Race?

Does the legal system discriminate against minorities? Systematic racial differences in the characteristics of legal cases, many of which are unobservable to researchers, make this a hard question to answer. Bertrand and her colleagues exploit the random assignment of cases to judges to answer a narrower question about racial bias: Do judges differ in how they treat minorities? The fact that cases are assigned randomly allows Bertrand to conduct her study without having to control each case's specific details. Using all felony cases in Cook County Illinois from 1985 through 2005, they examine, for each judge, incarceration lengths and sentence lengths for both African American and white defendants. They find large differences between judges, suggesting that at least part of the legal system treats minorities differently. In accounting for differences between judges, they find that a judge's age and previous work experience as a prosecutor or defender help to explain the differences in the treatment of minorities.

Other Projects in 2005–06

Does Corruption Produce Unsafe Drivers?
*The Costs and Benefits of Affirmative Action
in Education: Evidence from College
Admissions in India*
E-Governance as an Anti-Corruption Policy



Hoyt Bleakley

*Assistant Professor of Economics
and Richard N. Rosett Faculty Fellow
Graduate School of Business*

Does Uncle Sam Underwrite Emerging Markets? Partisan Politics, Bailout Guarantees and EMBI Spreads

From the Mexican peso crisis of 1994–95 through the Argentine crisis of 2001–02, concerns have been raised that international investors are not accurately assessing the risks of taking positions in emerging markets, particularly in government bonds. Rather, investors have become too cavalier, expecting to be bailed out by rich countries in the event of a crisis. If this is true, then borrowing by emerging market governments is being subsidized, raising the natural question of the size of the subsidy. Bleakley attempts to shed light on this issue by tracking the interest rate on emerging market government bonds during recent U.S. presidential elections. If candidates differ in their preferred approach to financial crises, then emerging market bond yields should respond to changes in candidates' fortunes as measured by the prices in the Iowa Election Market. Bleakley finds no significant correlation between bond yields and election prospects, suggesting any bailout subsidy is small or nonexistent.

Other Projects in 2005–06

*"Disease and Development: Evidence from
Hookworm Eradication in the American South"*
Quarterly Journal of Economics, forthcoming



Steven Davis

*William H. Abbott Professor of
International Business
and Economics
Graduate School of Business*

Electricity Pricing to U.S. Manufacturing Plants, 1963–2000

Efficient electricity pricing requires that electricity rates properly reflect differences in supply costs among customers. For example, rates should vary according to the customer's desired voltage level, distance from generating facilities and high-voltage transmission lines, and the volatility of the customer's need. Davis and his co-authors investigate how electricity prices and supply costs vary with annual purchase quantity for U.S. manufacturing customers. They show that prior to 1973 electricity pricing was remarkably efficient but that price schedules began to deviate from an efficient structure for smaller manufacturers after 1973. From 1980 onward, they find that prices charged for an additional unit of electricity to these smaller customers covered only 80 to 90 percent of the cost of generating the additional unit. Casual observation points to a change in regulatory practices to explain the change in pricing efficiency. During the 1970s, public utility commissions began to focus greater attention on the review and design of electricity rate schedules. Future work will investigate the pricing impact of greater regulatory intervention in rate design, in part by carefully identifying the timing and character of state-level regulatory approaches to rate design.

Other Projects in 2005–06

War in Iraq Versus Containment



Matthew Gentzkow

Assistant Professor of Economics
Graduate School of Business

Does Television Rot Your Brain?

Television was not uniformly introduced across the entire United States. Rather, television became available from the 1930s through the 1950s at different times in different markets, usually first introduced in large markets. Gentzkow and his coauthors take advantage of these differences in access to television to examine the impact of television viewing on young children. They combine data on student test scores for 6th, 9th, and 12th graders from 1965 with the timing of television introduction to create a dataset that measures performance for students who had little or no pre-school exposure to television compared to those that did. Contrary to prevailing wisdom, television viewing does not have a significant negative effect on test scores. In certain areas (reading, verbal, and general knowledge scores), Gentzkow finds that television actually improved test scores. For these areas, effects are largest for children from households where English is not the primary language, for children whose mothers have less than a high school education, and for nonwhite children.

Other Projects in 2005–06

What Drives Media Slant?



Austan Goolsbee

Robert P. Gwinn Professor
of Economics
Graduate School of Business

Internet and Cigarette Taxes

State taxes on cigarettes vary tremendously, providing a strong incentive to smuggle cigarettes from low tax states into high tax states. A state that increases its cigarette tax will see a drop in sales of cigarettes in that state, as the higher tax both discourages smoking and encourages smuggling. Goolsbee and coauthor Joel Slemrod demonstrate that over the past two decades, there has been a substantial increase in the sensitivity of the sales of cigarettes in a state to changes in the state's cigarette tax. They show that this increase in sensitivity is directly correlated to the rise of Internet usage across states and that the increase in the Internet has almost doubled the tax sensitivity of within-state cigarette sales. Data on cigarette usage indicates that the impact of the Internet appears to be concentrated entirely in the amount of smuggled cigarettes. Consumers respond to higher taxes not by smoking less but by smuggling more, lessening the revenue generating potential of recent cigarette tax increases by 33 percent. Given the continuing growth of the Internet and of Internet cigarette merchants, the results imply very serious potential consequences for states trying to raise cigarette taxes in the coming years, be it to raise revenue or to curtail smoking.



Ali Hortacsu

Assistant Professor
Department of Economics

Bank Merger and Acquisitions

Do firms expand to increase profits by taking advantage of efficiencies offered by a larger scale or by taking advantage of enhanced monopoly power? Ali Hortacsu hopes to shed some light on this long-standing question by using data from the banking industry, in the process providing guidance to antitrust policy in the financial markets. His work studies how banks and their respective branch networks expand, and how regulatory constraints on merger activity affect market structure. Recent branching deregulation has led to entry, exit, expansion, and mergers and acquisitions in the banking industry. In preliminary results, Hortacsu finds that banks generally tend to expand into territories that are adjacent to territories in which they already do business, and that banks typically gain toeholds into new markets through an acquisition that is followed by a flurry of branch building within the subsequent year. The next stage of the project will assess whether antitrust restrictions on market structure pose an important constraint on bank behavior, allowing for a judgment on how changes in antitrust restrictions may affect market competitiveness.

Other Projects in 2005–06

"Are Structural Estimates of Auction Models Reasonable? Evidence from Experimental Data"
Journal of Political Economy, August 2005



Steven Kaplan

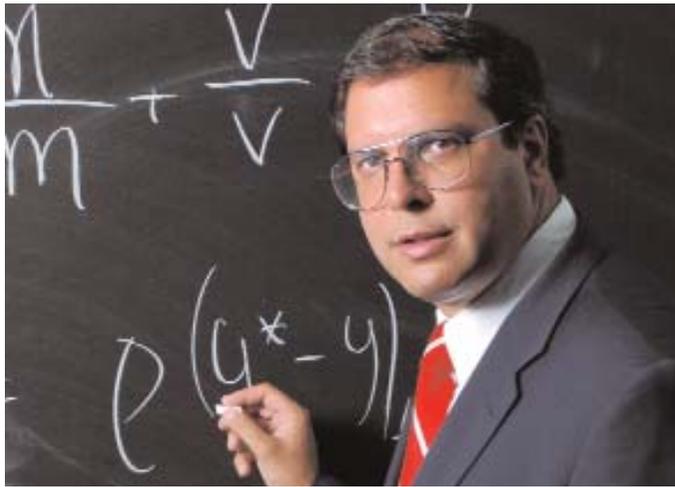
Neubauer Family Professor of
Entrepreneurship and Finance
Graduate School of Business

How has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs

Kaplan and Bernadette Minton are conducting a timely study of CEO turnover—both internal (board driven) and external (through takeover and bankruptcy). They examine the period from 1992 to 2004 using a sample of large U.S. companies and find an increase in CEO turnover relative to that estimated in previous studies over earlier periods. They also find an increase in turnover within their 14-year sample. For the period as a whole, the average tenure of a CEO is less than seven years, while since 1998 average tenure falls to just over six years. Turnover, whether brought about by a company's board or driven by a takeover or bankruptcy, is explained by three factors: the firm's performance relative to its industry, industry performance relative to the overall market, and the performance of the overall stock market. Board-driven turnover after 1998 is more strongly related to all three of these measures, although that is not the case for turnover resulting from takeovers and bankruptcy. In short, board evaluations of the CEO are becoming increasingly sensitive to performance.

Other Projects in 2005–06

What are Firms? Evolution from Birth to Public Companies
How Do Legal Differences and Learning Affect Financial Contracts?
"Private Equity Performance: Returns, Persistence, and Capital Flows" Journal of Finance, August 2005



Anil Kashyap

Edward Eagle Brown Professor
of Economics and Finance
Graduate School of Business

Reforming China's Banks

Under China's participation in the World Trade Organization, foreign banks will be allowed to enter China in 2007. Ahead of 2007, China is attempting to reform its banking system to ready it for the new international competition. Anil Kashyap and Wendy Dobson analyze this reform, focusing on the "Big Four," China's state-owned commercial banks that account for over 60 percent of Chinese banking assets. They find a major contradiction between the government's economic goal of internationalizing the Big Four and the political goal of continued state majority-ownership of the Big Four. Kashyap and Dobson closely examine the Chinese government's three-part reform plan: (a) cleaning out the legacy of nonperforming loans (NPLs) and recapitalize the banks; (b) finding international strategic investors to modernize bank management and strategy; and (c) listing the banks on the Hong Kong Stock Exchange to expose management to high standards of transparency. They find several risks to this strategy that threaten the profitability of the Big Four and propose reform alternatives that would resolve the contradictions between state ownership and the efficiency gains necessary to internationalize the banks.

Other Projects in 2005–06

*Zombie Lending and Depressed Restructuring
in Japan*

*How Banks Respond to Negative Shocks—
The Italian Experience*

*"Solutions to Japan's Banking Problems:
What might work and what definitely will
fail" in Reviving Japan's Economy: Problems
and Prescriptions, MIT Press, 2005*



Randall S. Kroszner

Professor of Economics
Graduate School of Business

Regulation and Deregulation of the U.S. Banking Industry

The banking industry plays a significant role in the financial system and has large effects on overall economic activity. The quality of bank regulation, which affects the stability, efficiency, and size of the banking sector, thus has an important effect on overall economic well-being. Randall Kroszner and coauthor Philip Strahan provide an overview of U.S. bank regulation as well as a discussion of the private and public interests that have shaped this regulation. Banking regulation has undergone tremendous change over time, with extensive regulations put into place in the 1930s that were later removed in the last quarter of the 20th century. The deregulation has been accompanied by a dramatic reduction in the number of banking institutions in the United States but not an increase in banking concentration at the local level. Kroszner finds that regulatory change has been driven by macroeconomic shocks, competition among interest groups within banking (and between banks and other financial services providers), and changes in technology. The development of the automated teller machine (ATM) in the early 1970s, for example, reduced the value of geographic protections to smaller local banks, thereby reducing their willingness to fight to maintain restrictions on branching. Economic crises—either system-wide as in the 1930s or to parts of the financial system as in the Savings and Loan Crisis of the 1980s—also have had important distributional impacts that bring about regulatory change. Although the industry adapted to the regulatory constraints imposed in the 1930s to partially reduce the costs of regulatory distortions, banking efficiency improved following the recent deregulation, generating substantial real benefits for the economy as a whole.

Other Projects in 2005–06

*Lessons from the U.S. Experience with
Deposit Insurance*



Tobias Moskowitz

*Professor of Finance and Neubauer
Family Faculty Fellow
Graduate School of Business*

The Political Economy of Financial Regulation: Evidence from U.S. Usury Laws in the 18th and 19th Century

Is regulation best understood as the product of private groups with political power attempting to capture rents at the expense of public interests, or as the product of a benevolent government intervening to correct market inefficiencies and maximize societal well being? This question has been the subject of intense debate in the economics literature, with seminal contributions made by Stigler Center founder George Stigler and current center researcher Gary Becker. Tobias Moskowitz uses an analysis of usury laws to move the debate forward, and in the process uncovers evidence in support of Stigler's "capture theory" of regulation. Usury laws, mentioned in the Bible and the Koran and dating back to ancient Rome, are regulations on the maximum rate of interest that can be charged on loans. Moskowitz asks whether usury laws are designed to benefit private interests with political power or to protect underserved or disadvantaged borrowers from predatory lending when creditors have market power. In examining the U.S. experience with usury laws during the 18th and 19th centuries, Moskowitz shows that incumbents and the elite used usury laws to control entry, hamper competition, and lower their own cost of funds.

Other Projects in 2005–06

"Bank Mergers and Crime: The Real and Social Effects of Credit Market Competition." *Journal of Finance*, April 2006

"Market Frictions, Price Delay, and the Cross-Section of Expected Returns" *Review of Financial Studies*, Fall 2005

"Do Liquidation Values Affect Financial Contracts? Evidence from Commercial Loan Contracts and Zoning Regulation" *Quarterly Journal of Economics*, August 2005.



Casey Mulligan

*Professor
Department of Economics
and the College*

Imperfect Political Competition in the Public Sector

Can economics shed any light on what explains the policies of different political regimes and what accounts for the success and failures of these regimes? Casey Mulligan thinks so, providing economic analysis critical at a time when the United States is attempting to encourage democratic values across the globe. Together with Kevin Tsui, Mulligan builds a model of imperfect political competition in the public sector that provides some fascinating insights into nation building. Mulligan's key insight is to apply the standard economic result that market power is more profitable in a large market than in a small one to the public sector. Accordingly, economic development improves the likelihood of democratization largely due to scale effects. As a country gets wealthier, there is more at stake in ruling that country, so an autocrat has a tougher and tougher time blocking political entry. In following the model's implications, Mulligan finds that nondemocracies will take more steps to acquire people and territory, whereas democracies will tend to avoid conflict with each other. The peaceful behavior of democracies is not explained by superior democratic morals, or the incapacity of democratic leaders to make important decisions, but rather as an outcome of the competition to manage the public sector. Perhaps most surprisingly, the model suggests that the composition of taxes, spending, and economic regulations is not determined by regime. A dictator clearly prefers more money to less, but the fact that his taking is limited by the threat of entry means that he will spend much of the tax revenue in the public interest in order to buy popular support and retain power.

Other Projects in 2005–06

"The Extent of the Market and the Supply of Regulation." *Quarterly Journal of Economics*, November 2005

"Conscription as Regulation" *American Law and Economics Review*, Spring 2005

"Political and Economic Perspectives on Taxes' Excess Burden" *In Toward Fundamental Tax Reform*, AEI Press, 2005

"Public Policies as Specification Errors" *The Review of Economic Dynamics*, October 2005.

"Non-response and Population Representation in the Sloan Study of Adolescent Time Use" *Electronic International Journal of Time Use Research*, 2005

"Estimating and Imputing Incomes for Middle-Class Families" *in Being Together, Working Apart*, Cambridge University Press, 2005



Kevin M. Murphy

*George J. Stigler Distinguished Service
Professor of Economics
Graduate School of Business*

War in Iraq Versus Containment

Forcible regime change in Iraq has proven to be an enormously costly undertaking. This high cost is sometimes seen as a compelling argument against the decision to forcibly overthrow the ruling order and install a new regime. Stigler Center researchers Steven Davis, Kevin Murphy, and Robert Topel make the case that this argument is deficient because it ignores the cost of the main alternative response to Iraq—the pre-war containment policy. Murphy and colleagues apply the tools of economic analysis to estimate the costs, as seen in early 2003, of these two leading policy options. When comparing war to containment they consider deaths of Iraqi and U.S. citizens, the prospects for an improvement or deterioration in the economic well-being of Iraqis, and the costs of military expenditures, humanitarian assistance, and reconstruction borne by the United States. Their analysis indicates that reasonable pre-war estimates indicated that the Iraqi death toll would likely be greater under containment and that forcible regime change would yield large improvements in the economic well-being of most Iraqis relative to their prospects under the containment policy. Finally, pre-invasion views about the likely course of the Iraq intervention imply present value costs for the United States in the range of \$100 to \$870 billion compared to an estimated present value cost for the containment policy in the range of \$300 to \$700 billion. Their work shows how basic economic principles and a quantitative approach can inform analyses of national security and humanitarian concerns presented by rogue states.

Other Projects in 2005–06

"The Market for Illegal Goods: The Case of Drugs"
Journal of Political Economy, February 2006.



Tomas Philipson

*Professor
Harris School of Public
Policy Studies*

The Speed-Safety Tradeoff in FDA Drug Approvals

The Food and Drug Administration strictly adheres to an evidence-based evaluation of the products it oversees. Thus, it is somewhat surprising that there is no generally agreed upon evidence-based methodology to evaluate the agency's own safety and efficacy. Tomas Philipson and his coauthors fill this gap by proposing a general methodology to evaluate FDA policies, using the speed-safety tradeoff facing the FDA as a particular example. First they estimate the cost and benefit of a major piece of legislation—the Prescription Drug User Fee Acts (PDUFA)—that resulted in quicker drug approvals by the FDA. Philipson and his coauthors then use data on the sales of drugs, as well as the review and withdrawal times of unsafe drugs, to measure the gains to both producers and consumers from the legislation. Their findings concluded that the more rapid drug approval process increased producer well being by between \$14 billion and \$17 billion while consumer well being increased by between \$5 billion and \$19 billion. Converting these economic gains into equivalent health benefits, Philipson finds that the faster access to drugs saved the equivalent of 180 to 310 thousand life-years. However, some drugs that were approved under PDUFA were subsequently withdrawn for safety reasons. Their methodology indicates that rapid approval for these drugs led to a loss of 56 thousand life-years. On balance, the more rapid approvals clearly benefited society.

Other Projects in 2005–06

*Surplus Appropriation from R&D and Technology
Assessment Procedures*



Chad Syverson

Assistant Professor
Department of Economics

Vertical Integration

Some firms choose to acquire their suppliers and/or their distributors, a process called vertical integration. For example, a car manufacturer might become vertically integrated by purchasing a steel mill. Chad Syverson and Ali Hortacsu examine a widely held view that vertical integration is often undertaken to enhance market power. The prospect of gaining monopoly power often brings regulatory scrutiny when a firm attempts to vertically integrate. Syverson and Hortacsu study the impact of vertical integration in the cement and ready-mixed concrete industries over a 34-year period. These industries have several attributes that make them an ideal case study, not the least being that vertical integration in these industries has drawn significant antitrust attention. However, Syverson and Hortacsu find little evidence that vertical integration enhanced market power in the industries. Instead, prices fell, quantities rose, and entry rates remained unchanged when markets became more integrated—just the opposite of what would happen if integrated firms were able to exercise market power. It seems that integrated firms can better coordinate the complex logistics inherent in the ready-mixed concrete business. These findings call into question the argument for more regulatory scrutiny of firms that integrate.

Other Projects in 2005–06

Vertical Integration and Plant Size



Robert Topel

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The Value of Health and Longevity

In 1900, nearly 18 percent of males born in the United States died before their first birthday—today, it isn't until age 62 that cumulative mortality reaches 18 percent. This remarkable increase in longevity reflects progress against a variety of afflictions and diseases. It illustrates a substantial, but unmeasured, increase in social welfare due to improvements in health. Stigler Center researchers Robert Topel and Kevin Murphy develop a framework for measuring the value of the gains in both the quality and length of life. Measuring these benefits is necessary to make any rational decision on allocating resources to health-care research and development. They find that the benefits are enormous. Gains in life expectancy over the century were worth over \$1.2 million per person to the current population. Looking ahead, Topel and Murphy estimate that even modest progress against major diseases would be extremely valuable. For example, a permanent 1 percent reduction in mortality from cancer has a present value to current and future generations of Americans of nearly \$500 billion, while a cure (if one is feasible) would be worth about \$50 trillion. Thus a “war on cancer” that would spend an additional \$100 billion (over some period) on cancer research and treatment would be worthwhile if it only had a 1-in-5 chance of reducing mortality by 1 percent, and a 4-in-5 chance of doing nothing at all. The policy implication of these large benefits is straightforward. Returns to basic medical research are quite large, so that substantially greater expenditures may be worthwhile.

Other Projects in 2005–06

War in Iraq Versus Containment
Immigration and the U.S. and European
Welfare States
Reforming the Swedish Welfare State



Luigi Zingales

*Robert C. McCormack Professor of
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The Media's Impact on Corporate Governance

In the wake of Enron, WorldCom, and reform efforts such as Sarbanes-Oxley, corporate governance remains at the heart of discussions on the performance of market economies. Luigi Zingales and coauthors Alexander Dyck and Natalya Volchkova pursue a new angle in this debate, examining the influence of the media on the practice of corporate governance. They use Russia as their laboratory, since during the late 1990s corporate governance abuses in Russia were very extreme, very common, and very visible. Moreover, standard mechanisms such as court actions to redress governance abuses were either nonexistent or completely ineffective. Zingales finds that the probability of a reversal of a governance abuse is significantly affected by the coverage of the event in Anglo-American newspapers, even after controlling for other potential determinants of the outcome, including the degree of foreign ownership and the involvement of international organizations, such as the European Bank of Reconstruction and Development (EBRD). By contrast, exposure in the local Russian press has no impact. In roughly half of the cases they examine, media pressure leads a regulator or a politician to intervene, while in the remaining half the company itself reverses the governance abuse under the pressure of media scrutiny. In sum, media coverage has an effect by increasing the reputational consequences of firm misbehavior vis-à-vis Anglo-American investors.

Other Projects in 2005–06

Does Culture Affect Economic Outcomes?

Are Elite Universities Losing Their

Competitive Edge?

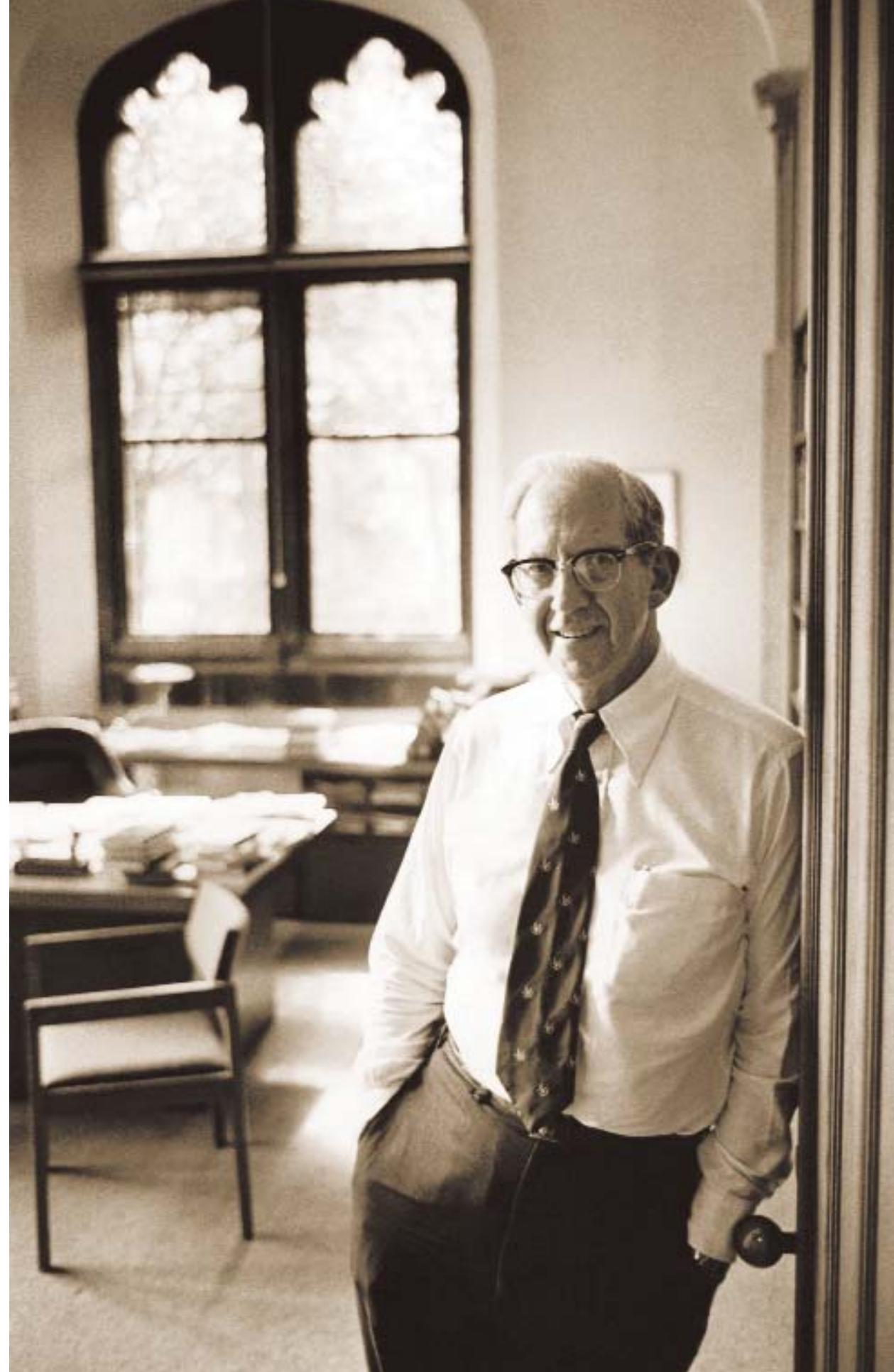
TRIBUTE TO GEORGE J. STIGLER

George J. Stigler



George J. Stigler joined the faculty of the Graduate School of Business and the Department of Economics at the University of Chicago in 1958. This event, together with the arrival of Merton Miller in 1960, is widely recognized as establishing the University of Chicago Graduate School of Business as a world leader in academic research and making it a full partner in an extraordinarily fruitful cooperative research enterprise with the University's Department of Economics and Law School.

Stigler was one of the great economists of the 20th century. He made seminal contributions to the economic theory of information and oligopoly and to the economic analysis of government regulation and the public sector. Stigler received the profession's highest honors, including the presidency of the American Economic Association and the Nobel Memorial Prize in Economic Sciences. His 1982 Nobel Prize was the first awarded to an economist whose primary appointment was in a business school.





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