

The Harvard College Economist

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Thank You

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THE HARVARD COLLEGE ECONOMIST

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The Harvard College Economist
E-mail: hce@hcs.harvard.edu
Fax: (617) 495-7730

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Editors' Note

The latest issue of *The Harvard College Economist* features several changes. With these changes, we hope to appeal to a broader audience while staying true to our fundamental purpose of publishing first-rate economics papers written exclusively by undergraduates.

In this issue, we offer a new editorial section with articles written by Judd Kessler and Andrew Reider, our two columnists. These editorials provide individual perspectives on current economic events and news. We have also expanded the staff of *The Harvard College Economist* in order to better represent the diverse interests of the undergraduate population. Senior Editors Emilie Feldman, Anna Joo, and Erin Perzov, and Assistant Editors Colleen Horan, Kayode Ogunro, Nadim Vasanji, and Ajit Vyas were invaluable in ensuring a high-quality publication. In addition, we have begun distribution of the journal to select libraries outside Harvard.

Finally, in this issue you will find several pieces which apply economics to non-traditional areas, such as prostitution, professional sports, and traffic problems. We hope you will find these innovative ideas as interesting and thought-provoking as we did.

For more information regarding submissions and staff positions, visit our web site at www.hcs.harvard.edu/~hce, e-mail us at hce@hcs.harvard.edu, or come to the informational meeting in the fall. We welcome you to send a Letter to the Editor via our website with any comments or suggestions concerning the content of the journal. We are always looking for enthusiastic students to write, format, and edit for *The Harvard College Economist* and we encourage anyone interested in the publication to contact us.

Sincerely,

Megan Todd
Editor-In-Chief

Ryan Myers
President

The U.S. Economy: An Interview with Professor Robert J. Barro

Robert J. Barro is Robert C. Waggoner Professor of Economics and is a regular contributor to Businessweek and the Wall Street Journal.

HCE: *How do you expect U.S. and world financial markets to perform over the next few years?*

RJB: Nobody can predict financial markets. I think the steep decline of U.S. stock market was related to new technologies, particularly those related to the computer and internet. There was a great deal of enthusiasm and optimism in those areas, and many thought that developments would be reflected in long-term improvements in productivity and profitability. People changed their minds about the commercial potential of this in 2000. That, more than any kind of bubble phenomenon, led to the big collapse. But that doesn't mean that I can project from here where it's going to go. It's the nature of the market being fairly efficient that you shouldn't be able to predict that.

HCE: *What about the economic health of the U.S. and Europe?*

RJB: There are a lot of problems. The best guess is that there will be a slow growth situation, but there are a number of factors that could make that worse. However, I'm not particularly pessimistic at the present time.

I would do more on the tax side if I were the Bush administration. I think that their tax package last year was basically a good idea, but the end result was a political compromise. They wanted to have more of the tax cuts structured in ways that would provide incentives for working and investing, but to get the measure through Congress, they had to make concessions that essentially just gave people money, particularly those in lower-income brackets. I don't think that provides many incentive effects or productivity effects. Overall, I thought it was a good idea, more than anything else because it took the money away from Washington so that they couldn't find anything to spend it on. It's not just Democrats, but Republicans too: When they had a

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lot of money and there were large budget surpluses, the main reaction was to find new programs on which to spend it or to increase existing ones. The education bill, agricultural subsidies, and health care initiatives were recent examples.

I think it's good that they got rid of the budget surplus. Part of it was due to the tax cuts and part of it was caused by the economy going downhill. Now, there is more pressure to keep down federal expenditures. A lot of the state governments now claim they have tight fiscal positions, but that's because most of them increased spending a lot when they had large sums of money and now they don't want to cut spending.

I would go further with the tax cuts: I would accelerate the tax rate cuts and try to have more that's favorable to business investment. I think the Bush administration will try to do those things, and given the November election results, I think they probably will succeed.

HCE: *You first introduced the "Ricardian Equivalency Hypothesis" in 1974. Do you think that the current and near-term tax cuts will provide any stimulus in light of this theorem? Will people spend the money if they believe that taxes may*

go back up in the future?

RJB: The Ricardian result applies under a particular set of circumstances. The two most important are first, a fixed path of government expenditure when you are talking about taxes versus expenditures, and second, lump-sum taxes which don't directly distort but just have money going in or out of the government. There's nothing in the Ricardian view that would say that changes in the marginal taxes would not matter; it is consistent with that proposition that they would matter. The timing would also matter. For example, when Reagan had the tax cuts in the early 1980s, it was a problem that the tax rate cuts were phased in over a few years. This created a situation at the beginning in which taxes looked high relative to where they would be a few years later. That's clearly contractionary. To some extent, the Bush tax cut did the same last year because most of the tax rate cuts were promised in the future so that the current tax rates (if you believed that promise) are higher than they will be later. This would actually motivate people to postpone expenditures.

The big debate about budget deficits was in the 1980s again under Reagan. After the recession of 1982-

1983, it was unusual that the government was running big fiscal deficits; given that the economy was recovering, that was an unusual pattern. I think it did have to do with the tax effects, but that didn't have ill effects on the economy. Although people talk about it now like it was an obvious disaster, the economy did quite well during that period: Interest rates and inflation came down substantially and investment growth did pretty well after 1983. Reagan wanted to cut both spending and taxes, but he was more successful in cutting taxes at the beginning, and that meant that there was a deficit. By cutting the taxes and reducing the revenue coming in, he did hold down the size of the government from what it would have been otherwise. I think that's also being the effect now from the 2001 tax cut; if we have another one, it will happen again. I think the Democrats tend to oppose it because they want more government expenditure.

HCE: *Do you think the U.S. should be worried about the possibility of deflation?*

RJB: It's Japan that people talk about usually in that context. You would think that the problem would be so basic, but

it is surprising how poorly it is understood. It has been a puzzle that Japan has been unable to get out of that situation for some time. For a while, policymakers were not being expansionary enough in terms of monetary policy, and they were thinking too much about interest rates which doesn't work when they get down around zero (which was pretty much the case in Japan). If you have a successful expansionary policy, you will get rid of deflation and move into positive inflation, and interest rates should go up and not down. For instance, if you printed a lot of money, you would expect interest rates to rise; there's something wrong with always looking for expansion when interest rates are falling. More recently, they have been printing more money, and there it has not had much of an impact. People are just holding it. Japan has provided the most poignant example of deflation, so we should look to them to learn about dangers for the U.S. It seems like when interest rates on government bonds are near zero, you have to buy other things to be expansionary. This is what Japan is considering trying: Printing money and buying other assets like equities or other private assets. I suppose that might be

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successful to get rid of deflation.

The U.S. is not in this environment currently. There are still plenty of other assets to buy. Greenspan was even talking about that the other day: Even if short rates are at one percent, longer-term government bonds will be at four or five percent and we can still buy a lot of those.

HCE: *Do you think that the overhanging bank debt in Japan creates problems that are distinct from the U.S.?*

RJB: I think that deflation is not the main problem in Japan. I think it has more serious problems. A lot of that had to do with overexpansion and overinvestment, and that is reflected in the bank loans. Also, they have had anti-market policies in terms of regulations and they were not very open in terms of international trade. Some structural differences exist too: There is a lot more cross ownership of equities so that a lot of this ties in more directly with the situations of corporations. This is a different structure from that which exists in the U.S. Those are more serious problems for Japan.

If I were in charge, I would try to be more expansionary on the

monetary side. I would try to get rid of deflation, but I don't think that would be any guarantee that things would be fine. I just think that deflation is a problem that can be solved in Japan, so why not do it? But I think the other problems are more serious.

HCE: *Corporate fraud has littered the headlines over the past year. Do you think the Bush administration has dealt with the situation well, and how should they continue to handle it in the future?*

RJB: I think the problem has been overblown. Politicians always like the idea of finding crooks and they think that a crusade against corruption and fraud will solve things. I think it's a minor part of the story. The main cause of the stock market collapse was overestimating the potential of new technologies. Not that the overestimation was something stupid; it was very difficult to know how to evaluate the commercial potential of internet companies. I believe that there is corporate fraud in some examples such as Enron, but I think it's a minor part of the overall story, particularly if you take a place like WorldCom which has admitted to misrepresentative accounting. I think that was a desperate

reaction to other problems like overinvestment in capacity which was not worth much. That's about \$100 billion in terms of money down the drain, so then they can have \$8 or \$9 billion of accounting fraud and they are still bankrupt.

I would have preferred if the Bush administration had focused more on providing a good climate for business rather than jumping on the bandwagon and attacking business and making it a broader problem than I think it is.

HCE: *What about the long-term fallout?*

RJB: I think the government will put on some more regulations, some of which will not mean much and some of which will cause trouble, like the new accounting board. Certainly, accounting could be made more transparent, but I don't know if that will come out of this. The correct treatment of things like options is not clear, and they don't seem to be studying it seriously.

HCE: *Your new book Nothing is Sacred just came out in September. You suggested that free markets can be applied to a wide range of issues. Can you provide an example, and do*

you think that there are limits to the application of free market theory?

RJB: My colleague Gary Becker is best known for extending economic analysis to a wide array of topics. Some of those things were the economics of the family and criminal behavior. I think a lot of that has been useful in terms in getting a better understanding of those topics. For instance, considering the capital punishment debate: I think a lot of it has to do with the deterrent effect. We would like to know how potential murderers respond to the punishment system. So I think it is an important extension, but in the end it depend on how well you can do with empirical work to see how important various factors are.

My first column in Businessweek had to do with the economics of beauty. I got in a lot of trouble for that. My most recent column deals with the question of what is the best monopoly in the United States. It talks about the post office, OPEC, Microsoft, and the Longshoreman's Union on the West Coast, but the NCAA was my choice for the best monopoly. They prevent college athletes from getting paid beyond a limited amount for scholarships. Obviously, that holds down financial competition and

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raises the profitability of college sports. But the really interesting aspect is that they seem to convince people that they have the high moral ground and that people who cheat, like colleges or donors trying to get around the restrictions, are evil and that the NCAA is doing the good thing by preventing the payment.

HCE: *What are your thoughts about the labor dispute that was just settled for West Coast port workers?*

RJB: The threat of the federal government was essential to the resolution. I think that the workers were scared that if they went out on strike again that the federal government would do something like send in the military to work the ports. Such intervention might have been popular. I remember when Reagan fired the air traffic controllers early on in his administration. That was actually quite popular at the time. Now, it's mostly labor unions that complain about it like it was awful, but in fact it was very popular at the time he did it. People didn't like all that disruption and it seemed to be a small union with an inordinate amount of power using it in

an inappropriate manner.

It would be an antitrust situation except that, for some reason, the labor unions have been exempted from the antitrust laws. But if you think about the intent of them in terms of monopolizing some sector and having great economic harm coming from that, it fits perfectly. The Sherman Antitrust Act of 1890, for example, was originally applied principally to labor unions. There was legislation later, such as the Clayton Act and Wagner Act, which changed that environment. These acts stated that labor wasn't an economic entity and therefore wasn't covered; it was very peculiar logic.

Antitrust law, in general, is not very productive as it is applied. You would think that we would want more or less parallel treatment on the sides of management and labor. It's not clear why you would want to apply it on one side and not the other, and labor unions often do a better job of monopolizing an industry. So, the asymmetry is a little peculiar.

HCE: *You wrote a paper earlier this year that dealt with the political factors which dictated IMF lending. Can you explain some of the main*

factors?

RJB: The starting point of the paper was that we wanted to assess the affect of IMF programs on economic growth. Normally, the IMF goes into places where there are problems, like a doctor stepping in to treat an illness, so it is not fair to blame the IMF for the existing problem. Nevertheless, if you were to judge solely from these existing problems, it would appear that the IMF was terrible. Therefore, you have to hold those conditions constant to give the IMF a fair chance.

Then, the genesis of this project was to do this and assess the real effect. We wanted to create an experimental situation in which the IMF was going in for some other reason than economic problems. Therefore, we conducted a political economy analysis of the IMF. They might go in because of the political connections between the country and the IMF or with the United States. We wanted to isolate the effect of the IMF on economic performance. We found a number of factors that seemed to matter: Having national representatives of the country at the IMF yielded a higher probability of getting approval, and having a UN voting record similar to the United States helped as well. The

IMF loan to Mexico in 1995, the first of the IMF's big lending packages, was the most obvious case of political influence. President Summers was a moving force behind the IMF's participation. After that, there were big lending programs in Asia, Russia, Brazil, Argentina, and other countries.

We found a number of variables that seem to predict the instances in which the IMF approves a loan, and then we used these to determine the effect of the IMF on economic growth. Once you took this into account, the IMF doesn't look nearly as bad. We did still find that the effect is negative, but not nearly as negative as if one observed the correlation between performance and IMF participation.

HCE: *You are teaching "Macroeconomics and Politics" this Spring. Is there anything about the course that we would not learn from reading the course description?*

RJB: I am going to start with the theory behind economic growth and incorporate empirical evidence to support it; I will then tie this into some political issues. I have been working a lot recently with my own research on religion and economics. Certain

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variables representing religion include church attendance, spiritual beliefs, and government involvement in religion (Communism, for instance, suppresses organized religion). I am looking at how economic development influences religion and how religion influences things like economic growth or democracy. The class will deal with issues such as this. ❖

Convergence: A Good Theory

Andrew Reider

After the frustrating 1980's, Latin America believed it could get back on track and reach high growth rates. The prescription was simple and suggested that if the region "did its homework"—which meant stop trying to solve economic problems with ineffective heterodox policies—it would be able to sit back and experience the sustained growth that East Asia had enjoyed. Much of the promise came from a relatively simple yet powerful notion at the heart of economics: the theory of convergence, whereby poorer countries should grow faster than rich countries under normal circumstances. Observers believed that convergence did not occur for Latin America since the late 1970's due to its centrally planned, protectionist, and distorted economies. Now, after several currency crises and at a time when even the region's institutional solidity is being tested, one cannot reasonably argue that economic theory delivered as promised. Many have blamed several factors to explain the region's underperformance, but one underdiscussed factor is the validity of

the underlying theory of convergence itself. Here I outline why the theory is a good theory but that its power has not been unleashed due to its inapplicability to the real global economy.

As Sachs and Warner explain, "the main reason for expecting economic convergence is that the poorer countries can import capital and modern technologies from the wealthier countries, and thereby reap the "advantages of backwardness."¹ This occurs, as Adam Smith ingeniously explained, due to the power of trade to promote growth through several channels: increased specialization, efficient resource allocation according to comparative advantage, diffusion of international knowledge, and heightened competition. Thus poorer countries should converge due to cheaper inputs such as land and labor, their increased return to capital investments, and the fact that the farther away one is from the technology frontier the easier it is to make large leaps in productivity.

In fact, elements of the theory of convergence have been confirmed by

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empirical evidence in cases where the model closely resembles reality. Just after World War II, for example, Germany and Japan's economies were in shambles but they quickly converged and are again among the richest economies. Since there was less capital in these countries—destroyed by the war—the new investment made the country grow faster than normal, supporting the notion that investment in capital yields greater returns in poorer countries. In the 1860's, the American states had disparate income levels. After the Civil War, the differences slowly disappeared as they became more fully integrated—this supports the ideas advocated by Adam Smith above. Furthermore, several studies show that convergence occurs within the OECD in the globalization eras: Jeffrey Williamson's 1995 paper on "Globalization, Convergence and History" "unambiguously" shows that convergence occurred in the late 19th century and late 20th century in the OECD.²

Meanwhile though, most of these papers admit in their introductions that global convergence does not really occur. Williamson states that his dataset includes a "club" of countries that "excluded, of course, most of the Third World and eastern Europe." This is be-

cause if he were to include them, he would reach Pritchett's (1997) conclusion that the ratio of per capita income between richest and poorest countries increased by roughly a factor of five from 1870 until 1990. Part of the problem is that the cases where the theory of convergence works are exactly those limited circumstances that the literature uses to support it. It is not that the theory is itself wrong (it is powerful as shown in the cases above), but that once one includes the full set of countries, the heterogeneous result including the different trade and economic policies produce a vastly complex reality that departs from the model. While most theories and models are not expected to fully explain the real world, this particular one faces a reality that is so utterly distorted from theory that its conclusions are diametrically opposed to what the evidence suggests (convergence rather than divergence). In fact, this is similar to other economic models of international scope, such as the Heckscher-Ohlin model's limitations in explaining real world trade patterns and of the international capital markets model in explaining international investment patterns (Feldstein and Horioka 1980). One possibility is that actual country interactions are far more complex than the economists' models,

similar to the problem the subfield of psychology and economics has uncovered in the models of humans' interactions.

Under this light, inferences of economic behavior from Williamson's "club" to general trends—such as Sachs and Warner's claim that once trade liberalizations spread in the 1990s the tendency towards convergence would strengthen—have proved misleading. Latin American exports *did* increase as predicted once countries liberalized, in fact they led the world in the 1990s. However, not only did convergence not occur, but these countries experienced rising inequality, enormous volatility, and economic growth rates below their post-World War II average. Furthermore the countries that converged, such as China and India, followed heterodox economic policies. Thus, despite convergence's power in some settings, it seems that economists' understanding of convergence explains little of how development occurs in practice.

To see how the real world economy acts in ways far from what the simplified theory suggests, it may be useful to adopt the perspective of a developing country's economy. Once one puts oneself in the position of a developing country, one can see how despite

the several advantages to backwardness that can produce explosive growth, "there are also strong forces for stagnation" (Pritchett).

First, the rules of the game are weighted in favor of rich countries. While there are several examples of this such as the TRIPS agreement, let's examine how the WTO makes developing countries feel like second-class members in terms of protectionism and the issues that are discussed. Despite the worldwide trade liberalization and hallowed era of globalization, when poor nations export to rich countries they face tariff barriers four times higher than those in North-North trade—to an extent this is due to agricultural protectionism, but there are other products like steel that are now coming to the forefront of international disputes. Protectionism in agriculture alone costs developing countries at least \$100 billion a year, which is twice the amount they receive in aid. Furthermore, while barriers to trade in goods, financial services, and investment flows fell significantly, Rodrik points out that international labor mobility has not been discussed, especially not in a multilateral sense, and remains highly restrictive. This would highly benefit the poor countries because they have excess labor and their work-

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ers would be better trained and could send remittances back to their home countries.

Furthermore, think of convergence from a firm's standpoint. Even if a company has a good product, it can hardly expand internationally unless it has a solid base. In developed countries and few large developing countries one's home market suffices to get enough scale for such an endeavor, but that is much harder in small developing countries; similarly this deters multinationals from creating export bases in these countries. The same problems a firm faces by not taking advantage of economies to scale are present in its R&D investment: because the home market's size is not big enough, the country overall does not invest in technology as it should. (Though these notions expose obstacles that local companies face they only reinforce the importance of trade.)

Perhaps the greatest problem is financing. While the principle of convergence at a micro-level suggests that a firm with a good and cheaper product should be successful, this may not be true in the real world regardless of the barriers to entry discussed above. This is especially true in countries with a high cost of capital such as Brazil whose local interest rates are 22%—such an

obstacle is almost insurmountable for a typical firm that would otherwise be competitive globally. While large companies can get around this obstacle, smaller companies and new entrants have a hard time becoming export-oriented, which is essential for convergence to occur.

These are only a few of the obstacles of backwardness that are present in reality. For convergence (or lack thereof) to be properly understood in terms of the world as it is, the models should account for these obstacles of backwardness along with the model's advantages of backwardness.

Nevertheless, anti-globalization and anti-capitalist rhetoric that simply dismisses the theory of convergence and Adams Smith's insights have it even more wrong because the theory is as strong as ever. The problem is not with the theory, but that the structure of the world economy and real international economic behavior does not act according to it. Much of it is still applicable to the real world as well—the successful examples of China and India unquestionably came from taking advantage of globalization. One task proposed above is for economists to address the disadvantages in their models better so that they can understand the

reasons for divergent economic growth. More importantly though, is to realize that divergence occurs not due to the theory's weakness, but instead because the conditions for convergence to occur have not been established. Once one realizes this, one readily sees that adamantly opposing globalization only

gets one farther from convergence, though merely opening up to trade is insufficient. ❖

¹ J. Sachs and A. Warner, "Economics Reform and the Process of Global Integration" (Brookings 1995).

² Jeffrey Williamson, "Globalization, Convergence, and History" (Cambridge, MA: NBER, Sep. 1995).

An Efficient Highway System: A Public Good

Judd Kessler

A highway system is the quintessential example of a public good. It is such a good example that high school economics teachers across the country use America's 2.4 million miles of paved roads to explain how some goods that, due to externalities, are under-produced by the private sector can, and should, be supplied by the government. These teachers speak truth, and one of the American government's major responsibilities is to construct and maintain the interstate highway system.

But while construction and maintenance of roads are necessary for an efficient automotive transportation system, they are not sufficient. An efficient system would also distribute cars

onto the highway in a manner that minimizes traffic and congestion. This distribution of cars is also a public good that the government should be responsible for providing.

Presently, Los Angeles rush-hour drivers spend 136 hours per year in traffic delays, according to the Texas Transportation Institute's 2002 Urban Mobility Study. Other major cities did not fare much better, and the study estimated that Americans wasted a total of \$68 billion in gas and time due to traffic in 2000. These tremendous costs fall on individual Americans, with an average Los Angeles "peak roadway driver" incurring annual costs of \$2,510. Clearly, the construction and maintenance of

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highways is not enough to meet drivers' needs and create an efficient system.

In many cases the government is limited in its ability to construct new highways. Certain interest groups lobby against highways, arguing that constructing more roads increases the number of drivers and pollutants. According to a New Yorker article on September 2, 2002, there are 40 percent more people and twice as many cars in America than there were in 1970, but road capacity has only increased by 6 percent. While road maintenance is necessary, it does little to alleviate traffic or decrease the costs of congestion.

The government must turn to another, often overlooked, tool of creating an efficient highway system. Disseminating information on traffic and road conditions to drivers would improve traffic flow and decrease the cost of congestion with only a small price tag for the federal government.

Presently, most information is transferred to drivers via private radio stations that broadcast traffic updates every ten minutes or so. In large metro areas, this information is often irrelevant to drivers' destinations or comes too late—many drivers find out they should have taken an alternate route when they are already stuck in traffic.

Some attempt has been made by the government to provide highway-specific information to drivers. Certain areas have radio broadcasts of highway updates that are advertised by signs on the side of the road. Other, more effective attempts include lighted overpass signs that change to describe traffic conditions further down the road. These signs are used in New York City on the Long Island Expressway (LIE), where a sign at exit 34 might tell you that traffic is heavy from exit 37 to exit 40.

But these measures provide incomplete information—they do not alert drivers of traffic levels on alternate routes. In the above example, I don't know whether traffic is heavy on the LIE because traffic is heavy on all eastbound highways, or if the LIE is particularly congested. There are time and gas costs to taking an alternate route, and without more complete information, I might be inclined to hold tight rather than take my chances.

In these cases, the difficult burden of information collection is placed on each individual driver. But when cars move from congested highways to less-congested alternate routes, drivers on both highways benefit from a faster ride. If enough cars switch from the heavy-traffic to the light-traffic highway, an

equilibrium is reached where all drivers are distributed efficiently among possible routes. At this equilibrium point, the highway system is being used to its full potential.

The information collection and dissemination required to make this efficiency possible is a public good just like highway construction, and should be considered responsibilities of the government. The government must look for ways to provide drivers with better information that can be easily synthesized for route decisions.

Fortunately, technology has made traffic data collection on highways easy: sensors on the road can determine the flow of traffic and analyze it instantly. And navigation system consoles, presently being installed in luxury cars, provide drivers with mapping software to locate their destinations and outline complete routes. Outfitting the navigation consoles to analyze traffic information distributed by the government would allow these two systems to work together to determine the fastest route to the driver's destination.

While only cars with these new, expensive navigational consoles would currently be able to use the information that the government provides, moving even this small number of cars from high-

density to low-density roads makes the system more efficient. As entrepreneurs enter the market to produce consoles, the price would drop, allowing more to benefit.

Whether you're sitting in traffic on I-95 or stuck bumper-to-bumper on the LIE, highway traffic information—necessary to help you decide on a faster route—is a public good, and the government should be responsible for providing it. ❖

Playing the Odds on Beacon Hill: Can the Massachusetts Clean Elections Law Save a “Democracy in Crisis?”

Rachael Wagner

Abstract

This paper uses game theory to analyze the structure of the Massachusetts Clean Elections program. The law’s potential for success in opening political races to new types of candidates and reducing the advantage of incumbency is evaluated through a series of payoff matrices between candidates of different fundraising capabilities. This analysis shows that, while the Clean Elections Law may increase the number of people who run for elected office, it will not necessarily alter who wins these elections.

I. Introduction

“Democracy is in crisis in Massachusetts,” or so the supporters of the Massachusetts Clean Election Law would convince us.¹ In 1998, the Massachusetts constituency supported a referendum on the Clean Elections Law, a bill that provides state funding for political campaigns that agree to adhere to a predetermined spending limit. One goal of the bill, according to its supporters, is to reduce the influence that private individuals, businesses and interest groups wield over the candidates who are forced to raise thousands to millions of dollars to mount successful campaigns. A second objective of the law is to en-

courage “non-wealthy” and “non-traditional” candidates to run, since “the need to raise large amounts of private dollars...creates an additional set of advantages for already-advantaged incumbents;” this, in turn, should lead to a more diverse, more representative governing body.² This concern about opening up the government to new candidates seems to be especially relevant in Massachusetts, a state where the legislature’s incumbent leadership is perceived to be so entrenched that a political action group went so far as to put a non-binding referendum opposing the re-election of House Speaker Thomas Finneran on the ballot.³

But can the Massachusetts Clean Elections Law actually accomplish these goals? According to Pam Wilmot, executive director of Common Cause Massachusetts – a group that played an integral role in the passage of the bill – this year’s implementation of the law “was just a toe in the water,” so it is too early to tell what the law’s effects will be.⁴ In this paper, however, I will conduct an analysis of the Clean Elections Law from an economic perspective. Using a game theory structure based on the principle that the results of candidates’ choices are constrained by the decisions of their opponents, I will analyze the decision-making processes that different types of candidates might use in choosing whether to accept Clean Elections funding. Of course, only empirical evidence over time will categorically prove the law’s success or failure in achieving its objectives of leveling the playing field for unknown candidates and reducing the importance of private contributions. However, the model is useful for the sake of studying the implications of the law’s structure in the abstract. The results are interesting: While the Clean Elections Law may have much success in changing who runs for office, we are unlikely to see any significant alteration in who actually gets elected in

Massachusetts.

II. The Structure of the Clean Elections Law

In 1976, the US Supreme Court ruled in *Buckley v. Valeo* that “the First Amendment denies government the power to determine that spending to promote one’s political views is wasteful, excessive or unwise.”⁵ This ruling came in response to the Federal Election Campaign Act of 1971, which sought to curtail candidates’ contributions to their own campaigns. More broadly, however, this decision put a decisive end to any efforts by the government to limit campaign spending and forced legislators to think of ways to incentivize candidates into accepting voluntary spending limits. This need for voluntary limits, combined with the public’s desire to reduce the influence of special interests, gave rise to the current structure of publicly financed campaigns, which generally involve a candidate’s voluntary agreement to a state-defined spending limit in exchange for state funding for his or her campaign. Private donations accepted under this scheme are usually capped at a low level, such as \$50 or \$100 dollars, and individuals are required to collect a specific number of contributions to prove that

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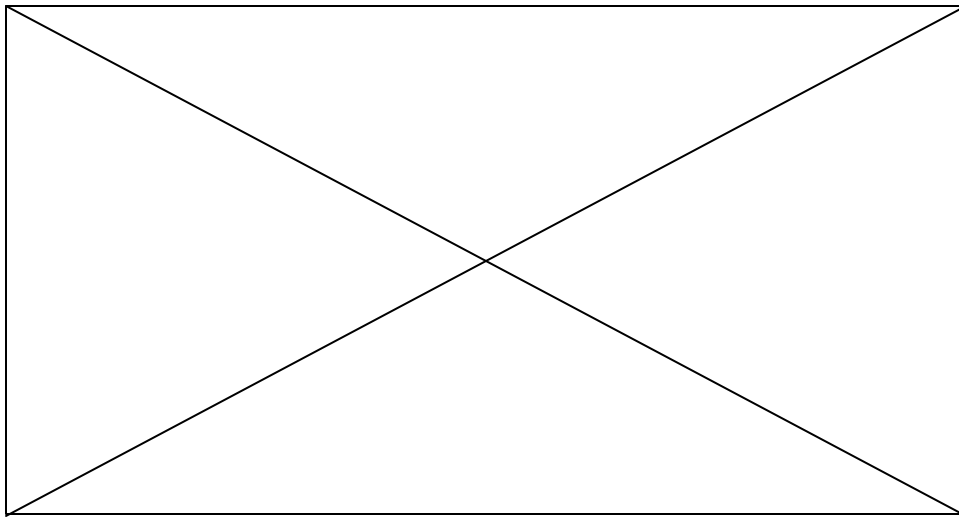
they are viable candidates before they are eligible to receive state funding.⁶

In Massachusetts, the Clean Elections campaign spending cycle begins March 31 of the year prior to a November election year, and candidates have until early June of the election year to file their qualifying contributions and register to receive public funds. The number of qualifying contributions (of \$100 or less) varies with the office, from 6000 for a gubernatorial candidate to 200 for a Massachusetts House of Representatives hopeful. Clean Elections Law candidates agree to the schedule of funding and spending limits below.

Clean Elections candidates who are unopposed in either the primary or the general election receive half the allocated amount for that unopposed race. Those candidates who are not applying for Clean Elections funds are

free to spend as much as they choose on their campaign, but they must notify the Office of Campaign and Political Finance (OCPF) when they exceed the Clean Elections spending limit. Once a non-participating candidate breaches the threshold, the Clean Elections candidate receives matching funds up to twice the original spending limit.⁷

Just looking at the small amount of data available on Clean Elections laws across the country, it is difficult to predict what the effect of the Massachusetts Clean Elections Law will be. Arizona, a state with a similar system of publicly funded elections, saw a 36% increase in the number of candidates running for office when the public funding scheme went into effect in 2000, as 76 additional people decided to run for office that year. In Massachusetts, however, only nine candidates legally



used public funds in their primary elections; of these, only four ran in contested primaries. In the four contested primaries, two candidates, Eldridge and Tolman, received matching funds when their opponents exceeded the spending limit, but only Eldridge advanced to the general election.⁸ Tolman was outspent by two of the opponents who subsequently beat him.⁹ O'Brien and Birmingham both raised more than twice the original spending limit, exceeding the maximum amount that Tolman could receive in matching funds.¹⁰ While conclusive data about the importance of money in Massachusetts elections was unavailable, this correlation between the amount of money spent and the number of votes received is not surprising. The League of Women Voters reports similar findings on the national level: "In 1998, 95 percent of [US] House winners and 94 percent of [US] Senate winners outspent their opponents."¹¹

III. Underlying assumptions

This statistic on the routine coincidence of high spending and electoral victory is important in that it shows what an important part of political strategy campaign spending can be. I will make a further critical assumption

that a causal relationship does indeed exist between the amount of spending on a campaign and a candidate's probability of being elected into office, based on the observation of the strong positive correlation between these two factors. However, before I address how a candidate –who has already made the decision to run for office— chooses whether or not to take public funds under the Clean Elections Law, I will outline the basic assumptions that underlie my model.

First, I assume for simplicity that there are only two types of candidates, those who are well known and could easily raise more than twice the spending limit (the maximum amount of public funds available) and those who are unknown and would have difficulty raising an amount greater than twice the spending limit. I will denote the former by K (as in "known") and the latter by U (as in "unknown"). Unless otherwise noted, every hypothetical candidate is a member of one of the two mainstream parties. I will, however, address third-party candidates later in this essay.

Second, empirical evidence leads me to feel safe in assuming that – in order either to win or at least to be a real player in an election – a candidate

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must spend an amount that is comparable to that of his or her opponents. This is especially important for unknown candidates who must work to establish a name for themselves through their advertisements. A third assumption that is tied to this axiom about the importance of campaign spending is that, in this model, I assume that all candidates are equally qualified and equally appealing to voters. Of course, this is not the case in reality, but in order for the model to have any relevance at all we must remove the effects of individual voters' preferences for particular candidates that may influence the outcome of the election. Although it is quite possible that the amount of money a candidate is able to raise reflects his strength and popularity within his constituency, for the sake of argumentation, I disassociate these two issues and examine fundraising capability purely as an exogenous endowment that the candidate brings to the campaign. Finally, I will construct my models as simultaneous-move, one-time games between the candidates who have decided to run, assuming complete information among the agents.

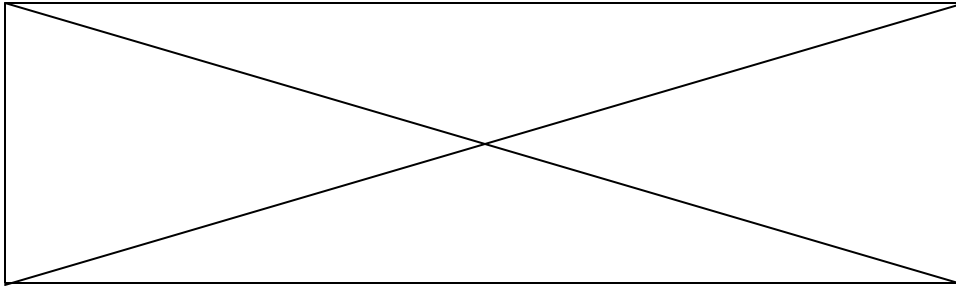
With these assumptions stated, let us now consider three different candidate pairings: two known

candidates, two unknown candidates, and one known and one unknown candidate.

IV. Game 1: Known vs. Known

In an election between two known candidates with equal appeal to voters, campaign spending is especially important, as it is each player's most effective way of distinguishing himself to the voting public. Under our assumptions, a candidate who spends much more than his opponent will win, but the outcome is uncertain when the two candidates spend comparable amounts of money. A payoff matrix for this game appears on the next page, where "clean" represents that the candidate uses Clean Election funding and "dirty" means that the candidate raises more than twice the spending limit:

In this game, it is doubtful that either candidate will accept the Clean Elections funding without 100% certainty that his opponent will also take the public funding. This is due to the fact that, under the Clean Elections Law, a candidate who accepts public funding and then violates the spending or in-kind contribution limits is sharply penalized. According to Section 16 of the law (*M.G.L. c. 55A*), a public funding



candidate who violates the Clean Elections Law must return all of the money his campaign was given by the state and must pay a fine out of his own pocket equal to twice the amount of the violation in question.¹² However, if both candidates agree to accept the Clean Elections money and if there is no threat of a third, “dirty” candidate entering the race, there is very little risk of either candidate defaulting because of the high cost of violating the Clean Elections Law’s provisions. Of course, each candidate should take into account the personal means of his opponent when deciding whether to take the Clean Elections funding; a candidate would be foolish to assume that a million-dollar fine would be enough to deter his billionaire opponent from defaulting on a Clean Elections pledge. Outside of these extreme cases, though, the penalties for violation are probably high enough to induce the “clean” candidates to keep their word. Thus for two known candidates, it is

unclear whether the Clean Elections Law will successfully decrease campaign costs and end candidate indebtedness to special interests. Since both known candidates could run without public funds, the law will not affect what sort of candidates enter this race, so that part of its mission is not particularly relevant to races like this one. As seen above, much of each candidate’s decision weighs on the actions of his opponent, since no known candidate will commit to Clean Elections funding without a guarantee that his known opponent will also volunteer to submit to the spending limit without any plausible threat of default.

V. Game 2: Unknown vs. Unknown

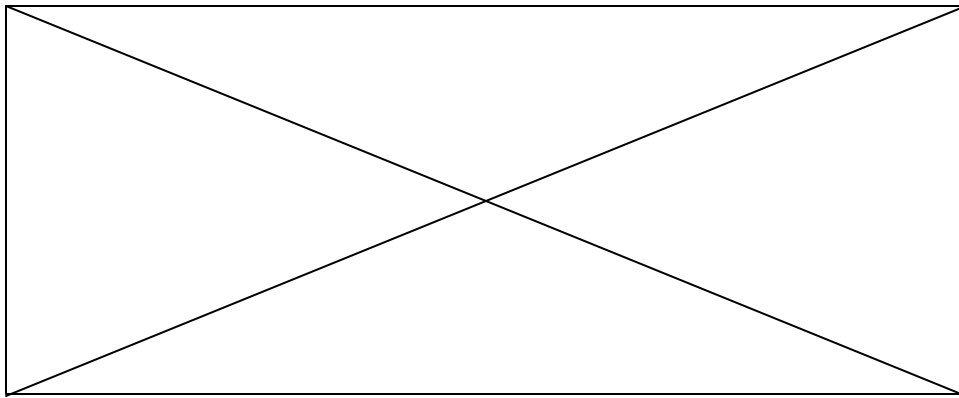
For unknown candidates with less fundraising prowess, the availability of public funding is most likely a major incentive to run when otherwise they might not have entered the race. In Maine and Arizona, two states with

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public funding programs, “most of the candidates who participated [in 2000] ... say they wouldn’t have run if not for public financing.”¹³ The law is very effective at opening up elections to new players for these sorts of candidates. Because these unknown candidates are not capable of raising over twice the spending limit and exceeding the available matching funds, an unknown candidate who runs on Clean Elections funding against another unknown candidate does not have to worry about his opponent being able to compete on “dirty” funds, as depicted earlier. A payoff between two unknowns is presented below, where “unclean” signifies that the candidate is not using Clean Elections funding but is unable to raise over twice the original spending limit.

Although two of the payoffs yield “equivalent funding,” it should be noted that the absolute amounts of

campaign spending in the upper left payoff (when both choose “clean” funds) is likely to be higher than in the lower left counterpart (when both choose “unclean” funds), if we assume that these unknown candidates have difficulty seeking large private contributions. However, for the sake of covering all possible cases, the matrix includes the situations where the unknown candidate can still raise above the Clean Elections cap but below twice the amount of the cap, even though in reality the Unknown will probably fail to exceed the first cap anyhow (if he could, a main purpose of the law would be void). The matrix reveals that the dominant strategy for the unknown candidates is to choose to use Clean Elections funding, whether or not the opponent is able to raise funds above the predetermined cap. For unknown candidates, the Clean Elections Law appears to be a complete boon, since it



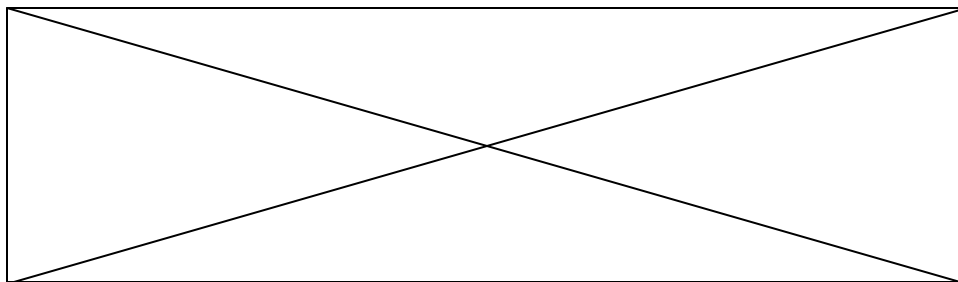
can only help their chances.

VI. Game 3: Known vs. Unknown

Elections between known candidates and unknown candidates are the most relevant to a discussion of the Clean Elections Law, since, according to Massachusetts Governor Jane Swift, one of the goals of the law is to “increase the competition for elective office.”¹⁴ As we saw in the first playoff between K1 and K2, the mere availability of Clean Elections money does not seem to play a large role in a known candidate’s decision to run for a particular office since he or she would be capable of raising enough money to mount a serious campaign regardless of the new legislation. Thus, the law is most important in situations where an unknown candidate challenges a known candidate. In Massachusetts especially, Clean Elections legislation has been strongly opposed by incumbents who dislike the leveling effect of the law, which makes it much easier for unknown

candidates to raise money and compete against incumbents. Prior to the law’s implementation, incumbents could use their status to significantly out-fundraise their unknown opponents. A playoff between a known candidate and an unknown candidate is shown below, where “dirty” represents the case where the candidate raises more than twice the original spending limit and “unclean” signifies that the candidate neither takes Clean Elections funding nor raises more than twice the limit.

In this situation, each player has a dominant strategy. As we saw from the previous playoff between U1 and U2, unknown candidates who cannot raise more than twice the spending limit will always take the public funding option. The known candidate, on the other hand, will not take public funding in a race against an unknown because this levels the playing field to the point at which the advantage of being well known is nullified.¹⁵ This is an interesting conclusion, as it implies that, while the Clean Elections Law may encourage



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unknowns to run against known candidates who have significant fundraising advantages, the better-known candidates probably will not participate in the Clean Elections funding system when they are opposed by unknowns. By decreasing the financial costs of entering the race for relative unknown candidates, the Clean Elections Law may fulfill its purpose of increasing the competition for elective office, but it may not actually affect who gets immediately elected to those positions.

VII. Third Party Candidates

Since the Clean Elections Law was designed to induce more people to run for office, we are likely to see an increase in the number of third-party candidates under this system. Because third-party (i.e. not Democratic or Republican) candidates are most likely to be unknown, they will probably take advantage of the public funding system under all circumstances, as our $U1$ vs. $U2$ and $K1$ vs. $U1$ payoffs demonstrated. As has been witnessed in Arizona and Maine, the public funding system is successful in enticing unknowns to run for office because it greatly decreases the cost (in terms of the candidate's own money and the

opportunity costs of time spent fundraising) of running for office.

Through the model outlined above, we can look at the effect that these third-party candidates have on the mainstream candidates' decisions to accept or reject the Clean Elections funding. In a race between two unknowns, the third party's involvement will have no effect, since both candidates' dominant strategy is to accept the public funding. Similarly, the involvement of a third party in a race between a known candidate and an unknown opponent does not change the mainstream players' decisions; if anything, it will make the better-known player even more resolute in her decision not to level the playing field by taking the Clean Elections funds.

In a race between two known candidates, however, the involvement of a third player can have an important effect. Whereas previously the two known candidates might have been able to agree to accept the public funding (since the result is equally ambiguous so long as they both act either to take or reject the funds simultaneously), a third party can destabilize this equilibrium. In closely contested races between two known candidates, third parties are especially dangerous, since they tend to

siphon off votes that previously would have gone to the two mainstream players. Because of this effect, the two main parties' candidates want to marginalize the third party candidate as much as possible; accepting public funding would put all three parties' players on the same spending level, so it is unlikely that either known candidate would consent to receive Clean Elections funding if a third candidate were involved. As we saw in the *K1* vs. *K2* playoff, neither player will agree to the spending cap without an identical guarantee from his opponent, so it is especially unlikely that the two mainstream candidates would be able to reach a Clean Elections-funded equilibrium if a threatening third party is involved.

VIII. Conclusion

As this series of games has suggested, the current political climate does not seem conducive to a successful Clean Elections system in Massachusetts. While the legislation does accomplish its purpose of increasing competition for elected office and may, in some cases, reduce the candidates' reliance on donations from private interests, it is not likely to significantly alter the strong position that incumbents and other well-

known candidates hold coming into an election.¹⁶ It is important to note that this is over only one iteration. Over time, as unknown candidates run for offices unsuccessfully but become well known in the process, the composition of the group filling elected positions in Massachusetts may become more representative of the population at large. This could occur as these unknowns are elected in subsequent races, which they enter as known (rather than unknown) candidates.

What, then, can be done to strengthen the Clean Elections Law? The idea of providing the right incentives for the candidates—the backbone of the Clean Elections Law—can be taken one step further. One possible solution is for supporters of the Clean Elections program to work to stigmatize those candidates who choose not to accept the voluntary spending limits. Right now, a candidate incurs no cost (besides the opportunity cost of having to raise his own money) for choosing not to participate in the public funding program. If this refusal to participate were instead portrayed as active opposition to democratic ideals, the cost of not participating would be higher, and the candidate would have to weigh the potential damage to his image against

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the positive image-building that could be accomplished with the excess funds he would be allowed to raise. Such a publicity campaign could effectively internalize the positive externality (of openness, fairness and issues-oriented campaigning) that the Clean Elections supporters seek by forcing the non-participants to bear the costs of the damage the Clean Elections system sustains due to their refusal to participate. Thus we see that, left as it is now, the system is not likely to achieve the democratic ideals it seeks. However, a serious publicity campaign against those who do not participate could significantly alter the candidates' decision-making processes and, in doing so, strengthen the effectiveness of the Clean Elections Law.

Endnotes

¹ Citizens for Participation in Political Action. The Campaign for Democracy in the State House < <http://www.overthrowfinneran.org>> cited 26 October, 2002.

² Daniel, Elizabeth. "Public financing: making it work." *National Voter*. 2001. 50:4, pp. 13.

³ Citizens for Participation in Political Action. The Campaign for Democracy in the State House < <http://www.overthrowfinneran.org>> cited 26 October, 2002.

⁴ Klein, Rick. "For 'clean' candidates, mixed results." *The Boston Globe*.

September 19, 2002: B1.

⁵ Hoover Institution. Buckley v. Valeo. < <http://www.campaignfinancesite.org/court/buckley1.html>> cited 26 October, 2002.

⁶ Daniel 10.

⁷ Office of Campaign and Political Finance. The Clean Elections Law. <http://www.state.ma.us/ocpf/ce_cover.htm> cited 26 October, 2002.

⁸ Kennedy, Denis. 2002a. Certified Clean Elections participants and amounts. [Web: email]. cited 26 October, 2002.

⁹ See the Appendix for a detailed table of Clean Elections expenditures.

¹⁰ Kennedy, Denis. 2002b. Phone interview. 25 October.

¹¹ Daniel 13.

¹² The Massachusetts Clean Election Law. <<http://www.state.ma.us/ocpf/chap55/55a.htm#18>> cited 26 October, 2002.

¹³ *Ibid*

¹⁴ Swift, Jane. "From Arizona, a lesson on Clean Elections for Massachusetts." *The Boston Globe*. June 18, 2001: A11. [LexisNexis].

¹⁵ It is important to be aware of the limitations of any model, so at this juncture I feel compelled to point out that this conclusion rests on our second assumption, namely that all candidates are equally qualified and appealing to voters. In reality, an incumbent or a well-known candidate probably has some sort of relevant experience that makes him or her more attractive to the constituents. In terms of sheer publicity, however, the Clean Elections Law significantly decreases the incumbent's advantage over an unknown candidate.

IMF Funding and its Limited Moral Hazard Consequences

Eric Powell

Abstract

This paper draws from theoretical and empirical work to demonstrate that the amount of moral hazard induced by IMF-funding is minimal. It explores the criticisms of moral hazard funding while demonstrating that the moral hazard is mitigated by a number of factors and illustrating that the IMF's system is in fact superior to alternatives.

I. Introduction

To think that policymakers pursue risky courses of action because they know the IMF safety net will catch them if things go badly is far-fetched.¹

[T]he IMF might consider changing its name to the IMH – the Institute for Moral Hazard.²

In the wake of the financial devastation of World War II, academics and policymakers from forty-four countries gathered at Bretton Woods to establish an international system of financial stability. The system adopted at the conference relied on free trade and fixed exchange rates tied to the dollar, which was backed by gold reserves. The con-

ference also established two major institutions—the World Bank and the International Monetary Fund (IMF). The World Bank was created to foster re-development in areas ravaged by World War II. The IMF was also a tool for rebuilding and preserving global prosperity; it was charged with maintaining the exchange rate, promoting a sound system of trade, aiding countries with balance of payment deficits, and assisting economically distressed countries.³

In 1971, President Nixon ended America's use of the gold standard, and in 1973 the major Bretton Woods countries agreed not to return to a fixed exchange rate system.⁴ This new world policy obviated the need for the IMF's central mission, supporting the fixed ex-

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change rate. The IMF, though, was not dissolved and has since maintained its involvement with international financial stability. The Fund accepted a more prominent role in offering money to alleviate insolvency, consulting nations on monetary problems, and advancing the growth of international trade.⁵

The IMF gained substantial influence in the 1980's for its assistance in the Latin American financial crisis.⁶ Since then, the Fund has lent money to, among others, Mexico, Russia, South Korea, Indonesia, and Brazil⁷, and the institution is currently involved in programs in over seventy countries.⁸ The increasing presence of the IMF has attracted global attention and sparked criticisms. Analysts often criticize the IMF's broad influence on crisis countries' policies, its ill-defined accounting procedures, and its distortion of incentives. It is this last point which this paper will address.

It is argued that IMF loans cause a moral hazard problem by distorting the incentives of creditors, debtors, and governments. Moral hazard arises when a situation fails to confer all penalties or all benefits to an individual. A rational agent will act to maximize his utility within this framework, potentially undertaking actions he would not pur-

sue if he were ascribed full responsibility.⁹ Fire insurance is an illustrative example of moral hazard. In an extreme scenario, a homeowner understands that if his property is damaged by fire, he will be reimbursed by his insurance company; therefore, except to avoid an inconvenience, there is no incentive for him to practice precautionary measures. To limit this irresponsibility, many insurance companies have deductibles or mandate that insurance holders use smoke detectors.¹⁰

Critics assert that the IMF fits this mold; they claim that the IMF induces a strong moral hazard for foreign investors, domestic debtors, and domestic governments.¹¹ From a theoretical perspective, the critics make a compelling argument. However, experience has not supported them. The degree of moral hazard is mitigated by a number of factors, and moral hazard alters incentives and influences decisions only to a minor extent. Perhaps even more relevant, though, is that the IMF's system, including its potential to cause moral hazard, is superior to alternatives.

The following section will expound on the conceptual issues regarding moral hazard and the IMF. Subsequently, to demonstrate that this model exaggerates the true degree of moral

hazard, the bulk of this paper will dispel hypotheses surrounding moral hazard and explore actualities that limit moral hazard. Finally, section seven will illustrate that although some reforms might reduce moral hazard, the current system should be maintained because it improves welfare.

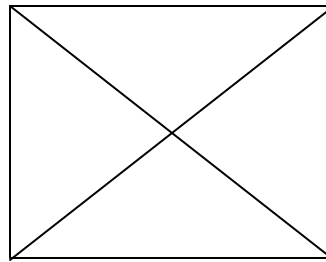
II. Conceptual Issues

*Countries such as Brazil and Russia would have had the appropriate incentives to implement good policies, instead of knowing that the IMF or the U.S. would respond to bad policies with showers of money.*¹²

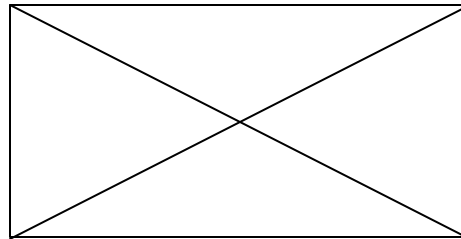
Conceptually, there could be a moral hazard problem for creditors, debtors, and governments. To demonstrate the altered incentives creditors face, consider a model depicting the returns of investment in foreign countries. Assume that foreign lenders provide an amount of capital C , expect that an interest rate r can be collected at time t , and realize that there is a probability τ that the debtor country will be forced into a liquidity constraint before time t . In one scenario, creditors know that the IMF will not bail out a country that defaults, and in another investors realize that there is a probability, m , that the

IMF will rescue an illiquid country. The inconvenience of trying to collect a debt is represented by s .

Investment scenario when IMF does not bail out countries:



Investment scenario when IMF bails out countries with probability m :



To understand why critics argue that investors face a moral hazard, consider the expected value of this loan at time t in both scenarios. In the event that there is positively no help from the Fund, $EV[C_t^{\text{No Funding}}] = \tau \cdot C \cdot (1+r) + (1-\tau) \cdot 0 = \tau \cdot C \cdot (1+r)$. In contrast, in the circumstance that the Fund may assist a crisis economy,

$$EV[C_t^{\text{Funding}}] = \tau \cdot C \cdot (1+r) + (1-\tau) \cdot [m \cdot (C \cdot [1+r] - s) + (1-m) \cdot 0] = \tau \cdot C \cdot (1+r) + (1-\tau) \cdot [m \cdot (C \cdot [1+r] - s)] =$$

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$EV[C_t^{NF}] + (1-r) \cdot [m \cdot (C \cdot [1+r] - s)]$. It is deducible that $m \cdot [C \cdot (1+r) - s] > 0$ because if it were negative creditors would accept \$0 rather than pursue the repayment of their loan. Also, $(1-r)$ is, by definition of r , nonnegative. Therefore, the expected value of capital at time t is necessarily greater if there is a possibility that the IMF will finance loan defaults.

As this model demonstrates, creditors do not bear the entire cost of making a risky investment. Consequently, investors would theoretically lend more than optimal amounts in risky situations.

This situation is exacerbated by the moral hazard of debtors. Consider the following example regarding debtors compiling a risky portfolio of short term loans. A bank that finances projects profits by borrowing at low interest rates and lending at high rates. Interest rates vary positively with the length of a loan because of a debtor's preference, *ceteris paribus*, for liquidity. Therefore, banks will borrow money for short periods and lend over longer ones. A bank can sustain these actions by rolling over loans. In this practice, banks fulfill obligations to debtors by issuing more loans.¹³

This process, though, causes

illiquidity if debtors recall their loans and there are no opportunities to issue new loans. Therefore, responsible creditors, and by law all American banks, maintain a level of liquid reserves. While these may not satisfy a severe bank run, they can quell a minor run. Likely this is also optimal for banks: They sacrifice an amount of profit to reduce the risk of going out of business. However, the prospect of the IMF making funds available to an insolvent institution reduces the downsides of illiquidity, such as borrowing at extraordinarily high rates or going out of business. Therefore, a debtor will accept more short term liabilities and hold less reserves than that of a bank which does not anticipate IMF support.

Banks can undertake other risky behaviors including failing to investigate institutions to which they lend or supporting particular projects on the basis of politics or familial connections. These actions can lead to insolvency and ultimately bankruptcy. Similar to the scenario presented above, the potential of receiving IMF funding in the event of a failure theoretically blinds banks to these consequences and encourages them to further pursue bad strategies.

In addition, IMF funding may cause policymakers to alter their courses of

action. For example, they may pursue careless fiscal policies, undertake irresponsible monetary policies, fail to regulate banks' behaviors, or engage in corruption.¹⁴ The existence of IMF funding limits the negative consequences of being unsuccessful, so a government may sacrifice more moderate policies for a small chance of large economic expansion.

In each of these cases, the same theoretical criticism of IMF bailouts emerges: if a risky venture has a high return, the business benefits; and if it proves to be a failure, taxpayers incur the loss through IMF funding.¹⁵ The following sections will demonstrate that evidence of such a problem existing is weak.

III. Increased IMF Presence Does Not Mean Increased Moral Hazard

*[T]he suffering that a country in crisis endures is already so severe that risk-prone parties quickly learn their lesson without lectures about moral hazard from well-meaning economists.*¹⁶

Critics often argue that the increasing size and frequency of IMF loans is evidence that a moral hazard problem exists. Loan numbers and val-

ues have in fact increased since 1995: in the last few years Mexico was offered the largest ever stand-by loan, Russia procured a long-term loan, and South Korea was granted a new record stand-by loan of \$20 billion.¹⁷ Constant IMF action, critics argue, confirms to lenders and borrowers in other countries that the IMF will not allow economies to fail. As the expectation of being bailed out rises, akin to an increase in λ in the model, risky behavior gains appeal. Realizing this, investors will fail, for example, to prudently evaluate commercial credit or foreign exchange risks.¹⁸

However, these theorists must remember that *crisis countries do suffer*.¹⁹ IMF funding is not a "get out of jail free" card. Not only does an economy in crisis necessitate sacrifices, the stipulations the IMF attaches to its loans can further raise unemployment and depress standards of living.²⁰ Just like that elusive "free lunch," IMF funding does not mean economies and their agents escape financial crises without paying dearly. So, while it is true that agents are aware of the increasing role of the IMF, it is also true that they know the suffering that crisis countries and their players endure. It is difficult to imagine that agents are naïve enough to believe

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risky behavior has no consequences. Recognizing the possibility of failure would not eliminate, but would certainly limit, the traps of moral hazard.

In addition, there are a variety of factors other than moral hazard that can account for the observed increase in frequency of IMF funding. Observers correlating increased IMF involvement with moral hazard may be underestimating the roles of intentional risk-taking, contagion, political instability, and economic shocks. Risk itself necessitates the possibility of failure.²¹ For example, if a bank loans only \$1 of its deposits, it is still accepting a risk that it can be illiquid. Since there is an element of risk in emerging markets, some of them will inevitably suffer from crises. This explains why crises have occurred throughout history, long before the IMF and its potential for moral hazard existed.²² However, why have multiple economies failed within a few years of each other? If there were no moral hazard, economies would sustain a relatively low probability of failing. It is therefore highly unlikely that so many economies, each with a small probability of complete dysfunction, would simultaneously be ruined. This reasoning is true with one major caveat: the probability of simultaneous collapses only

becomes infinitesimally small if each crisis is an independent event.

Cline argues that a number of the crises have been influenced by contagion; therefore, they should not be evaluated independently. For example, Thailand's currency devaluation forced Indonesia to also depreciate its exchange rate, and it played a decisive role in Korea's crisis. Then, contagion from the East Asian region contributed to Russia's declining equity and government bond prices. Subsequently, Russia's financial woes exacerbated an already precarious situation in Ecuador, and the crises in East Asia and Russia proved defeating for Brazil.²³ The recognition that some of these crises were the results of a "domino effect," combined with the fact that an element of risk invites the potential for an initial failure, presents a plausible explanation for the sudden splurge in IMF involvement.

Additionally, political climates can explain, at least in part, many of the crisis economies of the 1990's and the subsequent increase in IMF loans. Political uncertainty can likely send an economy into a downward spiral. For example, investors may rush to retrieve their loans because they fear that a tumultuous political situation will lead to a default.²⁴ Investor sentiment in Mexico

likely suffered from two political assassinations in 1994. Indonesia also experienced political volatility as observers wondered if the Suharto era would end with a peaceful transition and if regionalism would cede to unity. In addition, Ecuador's political problems likely affected its economy. Ecuador lost two presidents in three years—one was removed by the legislative branch and one was defeated in a military coup—and cycled through four finance ministers in just two years.²⁵ Surely critics of IMF funding would not dispute that such extreme political uncertainties have detrimental effects on an economy. Would they suggest that only moral hazard could have caused so many simultaneous political upheavals?

Exogenous shocks might also account for the rise in IMF funding. Shocks would simultaneously affect more than one country; for example, if OPEC raised oil prices, all oil-importing countries would be negatively affected. Calomiris²⁶ argues that there were no significant oil price hikes, wars, or autonomous decreases in demand since the 1980's. Although these more common shocks may not explain the crises of the 1990's, the possibility of other shocks should not be discounted. Weather damage from El Niño dam-

aged many crop-reliant countries, including Ecuador, and oil price changes hurt Russia's struggling economy.²⁷ In general, the existence of risk, contagion, political instability, and financial shocks demonstrate that an increased number of IMF loans is not conclusive evidence of a moral hazard problem. It may be a warning signal, but certainly combinations of other factors have played significant roles in recent economic crises.

IV. IMF Funding is Not Automatic

It is essential to remember that countries that border economic disaster do not automatically receive loans; funding is at the discretion of the Fund and the distressed country. Critics argue that m , the probability that the IMF will intervene with financial support in a crisis country, is quite high. Furthermore, it is asserted that the IMF currently cannot reduce m , or perhaps more accurately the expectation of m . This probability m , critics argue, is immovable because the Fund has bailed out too many countries to credibly threaten to stop.²⁸ However, m should be considered to be lower both because qualifications to receive IMF funding are strict and some countries prefer to avoid IMF loans.

The IMF requires and enforces

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strict conditions on countries that seek loans. IMF demands include fiscal, monetary, and structural adjustments²⁹, and political reforms.³⁰ These are not recommendations; they are contractual obligations, and the Fund withholds loans if the stipulations are not met. For example, promised money to Indonesia and Romania was delayed because the IMF was not satisfied with the countries' efforts.³¹ Although funding was ultimately resumed, the suspension should have reduced the expectation that IMF rescues are guaranteed.

Also, it is often ignored that not all countries accept IMF loans. Malaysia, for example, was in a similar position as Thailand in the late 1990's, but never reached an agreement with the IMF.³² This is likely a result of the conditions that the IMF makes debtor countries accept. Often, these required policies necessitate the uprooting of a country's government, banks, and corporations, a process policymakers hoping to be reelected would prefer to avoid.³³ Since it is widely known that the IMF attaches strict demands to its bail outs, economic agents realize that a country may reject loans, which further reduces m.

The conditionality of IMF loans reduces moral hazard by enforcing con-

tract breaches and making countries reluctant to accept IMF loans.³⁴ These are externalities that complement the true intention of conditionality, rebuilding a strong economy. Of course, these effects only reduce the probability that creditors and debtors will be bailed out, they do not eliminate this possibility. There are additional historical experiences that further reduce the expected value of future capital in the event of a crisis.

V. Creditors are Not Fully Insured

The model developed previously for investors derives the future value of an investment to be the same, except for a minor inconvenience factor, if a debtor remains solvent or if a debtor is rescued from insolvency. However, past rescue operations have demonstrated that this is not the case: creditors incur a financial loss if the IMF needs to bail out the debtor.

A few examples are striking in terms of the scale of creditor punishment. Russia and Latin America recognized only 70% of the present value of loans.³⁵ More devastatingly, foreign equity investors in some Asian markets recouped only 25% of their holdings.³⁶ Also, Ecuadorian policy was particularly

poignant: bond values were cut 40% in a process that did not even formally account for the views of creditors. Additionally, Thailand pursued a penal policy that entitled half of foreign creditors only to revenues from the auctions of debtor assets.³⁷

These instances illustrate the critical fact that creditors do not escape crises unscathed. Critics' claims that creditors are protected from loss are unfounded. While they only rarely lose their entire investment, they do incur costs for their risky behavior. This "punishment" lowers the expected value of an action below its full reimbursement level. In the context of this paper's model, $EV[C_t^{\text{actual}}] < EV[C_t^{\text{Funding}}]$. As a result, investors are discouraged from being excessively risky.

Critics, however, often charge that the losses are not substantial enough to precipitate changes in investor actions. The rescue of Mexico, for example, would be a prime candidate for inducing moral hazard because in a rare agreement the IMF package included the full repayment of all loans.³⁸ Critics often argue that investors' observations of the 1995 IMF bailout in Mexico motivated creditors to invest in Asia risk-free. However, in spite of the IMF's irregular agreement, the bailout

did not encourage Asian investors to incur more risk. The two economies were structurally different: Mexico suffered from a burdensome current account deficit, political instability, and a nearly fixed exchange rate, different problems than those from which Asia would later suffer.³⁹ Therefore, investment in Asia was not a function of creditors taking an extravagant risk because the IMF would cushion the fall. Instead, investment in Asia reflected that creditors learned a lesson in Mexico and invested in a region that did not suffer from similar maladies.⁴⁰

The Latin America crisis of the 1980's provide a more apt comparison to the Asian crisis because both were largely results of unsustainable debt.⁴¹ A comparison of these events further illustrates that investors learn from past mistakes. American creditors, who were largely involved in the Latin American crises, were more cautious in Asia than European and Japanese creditors who were first beginning to invest in emerging markets.⁴²

Creditor insecurities must exist because they manifest themselves in occurrences of contagion. If moral hazard were a substantial force, bank runs in one country would not occur, or would occur infrequently, in response to

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loan defaults in other countries. The critics' argument dictates that the IMF rescues insolvent debtors with near definitiveness, so observing agents will be encouraged to increase risky behaviors. Instead, experience has shown that crises, despite responses by the IMF, cause international panics not international pursuits of risk. For example, despite IMF agreements with defaulting banks in East Asia and Russia, Brazilian reserves fell 35% in just three months.⁴³ Similarly, Korean reserves dipped below \$10 billion.⁴⁴ These examples suggest that investors are more fearful that debtors will default than they are confident that the IMF will offer compensations. Of course, it is plausible that IMF rescues instilled trust in enough investors to prevent some bank runs. Still, contagion offers another situation that illustrates the limits of moral hazard. Creditors do learn lessons.

VI. Debtors are Not Fully Insured

The plight of debtors, similar to that of creditors, is under recognized by critics of the IMF. Feldstein⁴⁵ argues that past Fund interventions have established an expectation that debtors' loans will be guaranteed. Therefore, these borrowers engage in excessively risky

behavior, such as not properly evaluating commercial credit risks or foreign exchange risks.⁴⁶ However, IMF funding over the past ten years has shown that debtors do face financial consequences for risky behavior.

A number of debtor banks have been forced out of business or have struggled to regain customers. In Thailand, fifty-six finance companies whose lending patterns were particularly volatile and risky were closed.⁴⁷ The Asian crisis also shut down Indonesian and Korean banks.⁴⁸ Even those debtors that survive an economic crisis intact still face financial penalties. Defaulters face a loss of reliability that compromises their ability to attract new investors. To re-enter the capital markets, they need to slowly and convincingly regain a reputation of prudence. Mexico and Brazil suffered bitterly through this process in the 1980's and Indonesia was hampered by it at the end of the century.⁴⁹

Debtors do in fact face a risky situation with real consequences. However, not all defaulting debtors are forced to end operations and the costs associated with surviving are axiomatically less than those related to complete shut downs. As a result, the downside of overly risky behavior is not entirely felt by those engaging in it. This may ex-

plain why Thailand and Korea, among others, pursued Mexico's policy of linking debts to foreign currencies despite knowledge that it failed in Mexico.⁵⁰ It is impossible to determine without a counterfactual, but debtor punishments likely reduced the magnitude of irresponsible actions.

VII. Empirical Results

*[I]n the vast majority of instances, events that would plausibly have sent signals to markets regarding the availability and magnitude of IMF financing did not have the effects predicted under the hypothesis that moral hazard is important.*⁵¹

Lane and Phillips conducted one of the few empirical studies regarding IMF funding and moral hazard. The authors examined international interest rates and their movements with three categories of IMF-related announcements: IMF agreements with distressed countries, changes in IMF resources, and establishment of the 1998 program with Russia. This study shows that moral hazard is not likely a significant force in international markets.⁵²

Moral hazard is an inherently difficult phenomenon to measure because it is largely a function of expecta-

tions. This study uniquely accounts for this by evaluating interest rate spreads, which by nature reflect creditor and debtor expectations. In an open economy with full capital mobility, the interest rate is a combination of the world interest rate and a measure of risk.⁵³ This risk component includes all factors that increase the likelihood of debt default, such as political instability or potential exchange rate depreciation. If the expectation of default is high, investors will demand a higher interest rate to compensate for the increased risk.⁵⁴

The argument that moral hazard is a large force has specific implications for interest rate spreads. These seem to have been disproved. First, if agents perceive that the IMF guarantees debt, all interest rates should be the same; that is, the risk component will be zero and all interest rates will equal a single world interest rate. However, at the end of 1998, countries faced widely variant interest rates on standard US dollar borrowing. Israel, Malaysia, and Uruguay paid spreads of roughly 50 basis points while Ecuador, Indonesia, Kazakhstan, Russia, and Thailand faced spreads between 450 and 500 points and Ukraine's spreads on the same dollar were over 800 points.⁵⁵ It is particularly insightful that Russia and Brazil paid

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high spreads on a 1998 dollar, about 325 and 450 basis points respectively.⁵⁶ These countries were viewed as exceptionally immune to default—“too big to fail”—because it was believed that a large-scale crisis in either country would reverberate throughout the world economy and have dire consequences for the international balance of power.⁵⁷ Despite the widely held expectation that the IMF would rescue these superpowers, which would decrease risk, their interest rates reflected some of the highest risk components in emerging markets. This paper will now examine changes in spreads to build on this preliminary evidence that IMF bailouts do not assure creditors that their investments are safe.

If IMF funding were integral to the risk of assets, then announcements regarding the commencement of bailout programs in crisis countries would reassure investors worldwide and lower interest rate spreads. In this study, the spreads of the emerging market bond index (EMBI), normalized to the standard deviation of historical changes, contradict such moral hazard arguments. As discussed previously, critics argue that the full bailout of Mexico in 1995 incited the crisis in Asia. However, in conjunction with IMF announcements

regarding the bailout, interest rate spreads moved in the opposite direction that moral hazard would predict. When rescue negotiations were announced, EMBI spreads jumped a considerable 199 points, or a normalized 4.0 ratio, and the approval of a plan further increased spreads. Although a recommendation for increased funding lowered EMBI spreads, it sustained itself only for a day or two as spreads rapidly increased for two more months. Similar results emerged from the study of financial arrangements with Thailand, Indonesia, and Korea in 1997. The separate announcements of IMF negotiations with each of these countries did not result in a significant EMBI change. Although the approval of rescue plans in Korea depressed bond spreads, the approval of plans for Thailand did not affect spreads, and the approval in Indonesia increased ratio spreads 1.2 points.⁵⁸ Evaluated collectively, movements in bond spreads around announcements of funding negotiations and approvals conflict with the contention that moral hazard is a significant factor in lending decisions.

Similarly, bond spread fluctuations surrounding announcements of increased IMF resources do not support the existence of a strong moral hazard

problem. Creditors would likely interpret IMF actions to increase resources as signals that the IMF is willing to increase the size and number of rescues; therefore, if moral hazard is significant, announcements regarding more resources should decrease EMBI spreads. In contrast, a 1994 increase in access limits coincided with a rise in bond spreads.⁵⁹ Additionally, the creation of a Supplemental Reserve Facility, a measure that makes large, short-term support more accessible, had almost no effect on spreads.⁶⁰ Finally, the 1999 general increase in quotas actually raised ratio spreads 1.4 points.⁶¹ Critics argue that this final correlation is irrelevant because after US approval of the increase, which was associated with sizable spread decreases, the general confirmation of the increase was largely anticipated. This criticism, though, fails to recognize that a surprise rejection of the increase by a U.S. Congressional committee did not have any repercussions in the bond market. The spread decrease at the time of U.S. approval could appropriately be explained by surprise rate cuts by the U.S. Federal Reserve less than a week earlier. Again, bond prices, measures of perceived risk, do not vary with indicators that increased resources are available in the manner that

moral hazard would predict.⁶²

A study of EMBI spreads with regards to Russia in 1998 may loosely support the presence of a moral hazard problem. Russia was forced to default on government debts in August 1998, and the IMF did not immediately bail out the country. This lack of IMF action surprised most observers who believed the IMF would always rescue Russia to avoid systemic collapses in the international economy. As the moral hazard argument would predict, spreads increased significantly around the news of Russia's default. However, a significant portion of the change is accounted for by Russia's inclusion in the index. Also, the spreads remained flat around other announcements regarding IMF relations with Russia, perhaps indicating that unaccounted for variables affected the August 1998 EMBI market.⁶³

The argument in favor of moral hazard relies on the assumption that IMF practices cause investors to reduce their expectations of risk. Levels and changes in interest rate spreads seem to reject the presence of severe moral hazard.⁶⁴ Investors do not act as if their loans are fully guaranteed by the IMF.

Does the case of the Russian default mean that there is a moral haz-

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ard problem with “too big to fail” economies? Unfortunately, any definitive study of moral hazard requires the elimination of countless confounding variables and the inclusion of counterfactual evidence.⁶⁵ Since such a resource will never be available, it will be fruitful to now compare the current IMF system to a hypothetical institution.

VIII. Alternatives are Inferior

The IMF was created in part to stabilize the international economy, and it still fulfills this worthwhile purpose. Global markets, like domestic ones, require a framework to be successful, and the IMF largely fulfills this essential role.⁶⁶ Unfortunately, the IMF has some undesirable features. Although it has been shown that the amount of moral hazard associated with IMF lending is likely minimal, it is still a concern and could potentially become a more serious problem in the future. Therefore, it is relevant to weigh the costs of moral hazard against the benefits of IMF funding and to consider alternatives that may further tip the balance.

IMF funding serves a valuable function in the world economy, and it would be reckless to end this practice just to avoid a minor moral hazard prob-

lem. Disbanding the IMF would require debtors and creditors to independently reach solutions, a process that has historically been lengthy.⁶⁷ In contrast, IMF funding facilitates more rapid arrangements and reacceptance of economies in the international capital markets.⁶⁸ Capital markets painfully excluded Mexico after its 1980’s crises, but they readily accepted Mexico in the 1990’s when the IMF assisted in the recoveries.⁶⁹ Similarly, South Korea and Thailand have not had to endure severe restrictions.⁷⁰ In fact, Cline argues that “[t]here is no doubt that the impressive economic recoveries in Mexico, Korea, Brazil, and to a lesser extent Thailand would not have happened without the confidence supplied by the official support programs.”⁷¹ The categorical expulsion of economies from these markets, assuming they have been rebuilt, is detrimental to the country’s economy and inefficient for the world economy.⁷² Therefore, since the IMF can offer credibility to economies, the Fund’s efforts should be supported.

There are serious global consequences for stopping IMF involvement in addition to market inefficiencies. IMF loans reduce the large variations and systemic effects of international capital flows, which helps contain cri-

ses and curtail global contagion.⁷³ Moderating the extent of contagion is valuable: It is hardly worth risking a global economic downturn to prevent minor distortions of incentives to be risky. In addition, some economic collapses can have immense political ramifications. For example, IMF policy has been criticized in Russia because the Fund repeatedly lent money despite Russia's sluggish efforts to reform.⁷⁴ However, the alternative was far scarier than potentially inducing a moral hazard problem—political and economic confusion, instability, and collapse in a country with substantial reserves of nuclear weapons.⁷⁵

The costs of eliminating IMF funding, namely extended suffering, international market inefficiencies, potential widespread contagion, and possible warfare, are incomparably more detrimental than the slight costs of moral hazard introduced by the current system. The present operations of the IMF, though, are not perfect and can likely be improved by a number of reforms. IFIAC⁷⁶ presented a number of recommendations to the U.S. Congress, some of which have implications for moral hazard and will be discussed below.

The IFIAC report suggests that a member country that meets “minimum

prudential standards” should automatically receive IMF funding. This measure is intended to prevent the IMF from jeopardizing government sovereignty by implementing policy reforms⁷⁷, but unconditional lending would likely introduce a more serious moral hazard problem.⁷⁸ There would no longer be the element of doubt that is essential to reducing moral hazard. It would be obvious, *a priori*, if the IMF will offer crisis-time assistance, and countries would no longer be reluctant to accept this funding. Therefore, agents' expectations will change and, despite other mitigating factors such as losses these agents will still incur, their behavior will be riskier.

In addition to restructuring the requirements for lending, IFIAC recommends that the terms for lending be changed. The Commission advises that IMF loans have a maturity of only 120 days and rates that are greater than those paid one week before applying for an IMF loan.⁷⁹ As Meltzer argued before Congress in 1998, penalty rates achieve the sought after end of making IMF funding undesirable. Likely, the short duration would also make IMF loans less attractive. The acceptance of these reforms would make IMF funding a true final resort. In an effort to avoid a pun-

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ishing IMF, moral hazard would be reduced and financial responsibility would be encouraged.⁸⁰ Birds objects to these suggestions because penalty rates and short duration loans ignore longer term development and poverty problems.⁸¹ IFIAC recognized this and proposed that such projects be left to the discretion of the World Bank.⁸²

IFIAC further recommends greater disclosure by member countries. This would include the regular publication of borrowing countries' "outstanding sovereign and guaranteed debt and off-balance sheet liabilities."⁸³ Increasing information will enable creditors to conduct more detailed and proper evaluations of economies' risk levels.⁸⁴ Also, the resources to observe official values of losses suffered by other creditors will discourage excessive risk taking. Additionally, reports would be used as factors in determining if the IMF should extend lending to a country.⁸⁵ Therefore, there is an incentive for countries to pursue sound policies so they can present encouraging reports.

IX. Conclusion

Despite the dire warnings of critics, IMF rescue operations are unlikely to induce a significant moral hazard problem. The major arguments that

moral hazard is a serious problem in international capital markets are based on theory that dictates that such a problem *should* exist. However, experience has shown that a number of factors severely limit the degree of moral hazard. International watchdogs should not advertise problems where they don't exist.

However, this should not be regarded as a reprieve for the IMF. The member countries should be wary of reforms that would increase moral hazard, as it could potentially become a more legitimate influence. Similarly, the Fund could and should adopt a number of reforms that would further reduce moral hazard and enhance its effectiveness.

In fulfillment of the IMF's objectives, the Fund has had extraordinarily positive effects on the growth and stability of the world economy. The Fund should be cognizant of its potential to induce moral hazard, but in no way should the IMF shy from its mission.

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An Antitrust and Economic Analysis of Franchise Free Agency in Professional Sports

David Kessler

Abstract

One section of antitrust law focuses on the relationship between professional sports leagues and their constituent teams (franchises). The fundamental question for this branch of law is whether or not a sports league has the legal right to block the relocation of its franchises. The answer depends on the legal connection between sports league and franchise. If a league is considered a large business with many subsidiaries, a "single entity," then such a blocked relocation would not be anticompetitive. But if the league is, instead, viewed as a loose combination of unique and distinct business, such a restriction by the league would violate the Sherman Antitrust Act. This paper will argue that, for the purposes of legal decisions regarding franchise free agency, a sports league should be considered a single entity. There are legal and economic arguments for such a designation. First, the current structure of professional sports leagues fits the legal definition of a "single entity." Second, even if such leagues consisted of legally separate businesses, the economic and social benefits created by considering sports leagues to be single entities outweigh the economic losses such a designation incurs.

I. Introduction

In the past twenty years, a small but lively area of antitrust analysis has developed around the question of franchise free agency. Franchise free agency refers to the ability of sports teams within a league to move freely from one city to another. For instance, the fabled migration of the Brooklyn Dodgers from New York City to Los Angeles repre-

sents the relocation referred to by franchise free agency. The question posed for scholars of antitrust has been whether or not a sports league, like Major League Baseball in the example above, which attempts to control the relocation of its teams, is violating antitrust law. The Sherman Antitrust Act, section I, forbids every "contract, combination in the form of trust or otherwise, or con-

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spiracy, in restraint of trade or commerce.”¹

Whether or not relocation restrictions violate the Sherman Act depends largely on how one views a sports league. If the league is the combination of many distinct teams acting together, then any action taken to control team relocation would restrict the legitimate competition between those teams. If the league, on the other hand, is a single entity, an organization functionally different from a simple collection of teams, then relocation restriction would be acceptable because the league would simply be arranging different parts of one business.

This paper will consider legal, economic, and social arguments for and against granting a sports league single entity status. It will conclude that, for the purposes of franchise free agency, a league should be considered a single entity because that status best represents the relationship between member teams and the league. Moreover, even when a league acts more like a group of teams rather than a single entity, the benefits of treating the league as a single entity, such as product quality and fan loyalty, outweigh the inefficiencies, such as higher ticket prices, caused by such a designation.

II. Definition of the Product Market and the Geographic Market

A sports league collectively produces one product: sports games.² While the number of teams required to produce that product varies, there clearly must be more than several teams in the league for any reasonable number of games to be produced.³ No one team can produce a game, and even two teams would hardly constitute a league. Furthermore, it is difficult to argue that a sports league can produce anything but sports games. They do produce revenue, but only through ticket and advertising sales linked to their games. More intangibly, they produce entertainment and the desire to compete athletically. Even these “services,” however, are directly linked to the production and viewing of the games themselves.

The definition of the market for sports league games includes an explanation of both the product market and the geographic market. The product market refers to the amount and type of competition faced by the league. The University of Chicago Legal Forum details two types of markets used in sports instance, the market for the NFL (National Football League) would be football games. Either of these definitions is

suitable for the current argument about sports relocation analysis, and both are considered below. The geographic market refers to the scope of potential competition or monopoly, whether it be on a regional or national scale. Ross and Dale both give evidence that, when considering the league's antitrust action, the relevant market in question should be national.⁵ The court in *Oakland Raiders I*,⁶ however, found the best market definition to be regional.

Definition of the product market as either a single-sport market or the entertainment market proves difficult since there are strong arguments on both sides. The single-sport market argument has been advanced by the courts in *Raiders I* as well as in *NCAA v. Board of Regents*, in which the court found that the football telecasts in question "generate an audience uniquely attractive to advertisers."⁷ Fisher, however, argues that "the national market for entertainment products" should be the relevant market.⁸ The inability of a sports team to exercise monopoly power demonstrates that an individual sports league is only one competitor in a larger market. "Monopoly power in an output market involves the ability to charge high prices *without* offering superior products,"⁹ explains Fisher.

Sports leagues certainly do not have this power; higher ticket prices come with increasingly luxurious stadiums, more sophisticated television coverage, and bigger, flashier players. Furthermore, the substitutability between college and professional teams as well as between local and national teams assures that no team or league can hold its audience captive. Without strong empirical evidence, though, choosing between single-sport and entertainment market definitions is extremely difficult. The Chicago Legal Forum explains: a definition of the single-sport market places a higher burden on those defending relocation restrictions; this paper will adopt that definition.

The market for sports games is both regional and national. In any given city, the majority of fans of a particular sport will be interested primarily in the success of their own team; for example, few New Yorker's regularly follow the Kansas City Royals. Sports teams have always been rooted in specific locations; this local base is important for the success of their products. As Fisher explains, "local knowledge and local contracts are likely to prove very desirable in dealing with local authorities and local media."¹⁰ The product, however, sports games, cannot be produced ex-

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clusively in one market with any great success. The variety of teams and general league presence which entice fans are drawn from across the entire country. Thus, it is difficult to argue that the NFL's market is New York City, San Francisco, or any one other city. Such a narrowing of the market has been proven necessary¹¹ only when analyzing the antitrust implications of one specific type of relocation, namely when a team moves to a region in which another team in the same league already exists.¹² This paper will consider both possible geographic markets although only the regional market raises antitrust questions which are discussed in the next section on the single entity question.

III. Sports Leagues Should Be Considered Single Entities

Given that sports league produce sports games in either the national or the regional market for those games, the important question for this analysis becomes whether the league should be considered a single entity or an organized aggregation of independent teams. If the league is considered a single entity for the purposes of analyzing franchise relocation, its restrictions will be exempt from antitrust analysis. Each

franchise would be considered an inseparable part of the whole and the league would be free to move that part as it desired, just as the Staples Corporation might move Staples office stores at its discretion. If the league is not considered a single entity, then its relocation restrictions may disrupt legitimate competition by preventing teams from moving to more profitable locations or into markets where they can compete with other teams in the same league. This section will argue that a sports league should be considered a single entity for two reasons: First, teams in a league do not compete economically in the market for sports games; second, teams are incapable of producing sports games outside of the league context, it is only the cooperation of teams which creates the desired product. After proving that a league should be considered a single entity, this section will refute the arguments about why a league should not be considered a single entity presented by the Appellate Court in the Oakland Raiders case and legal scholar Jeffrey Glick.

A sports league should be considered a single entity because different teams in the same league do not compete economically in their national market. The Supreme Court judicially es-

established this concept about competition in the *San Francisco Seals* case by stating that “member teams of the NHL [National Hockey League] did not compete in an economic sense.”¹³ The San Francisco Seals sued the NHL when the league blocked the team’s relocation to Canada, arguing that the NHL violated the first section of the Sherman Act by restricting competition in the hockey market.

Furthermore, leagues should be designated single entities because an individual team is not even capable of functioning as an independent producer because it can not produce games on its own. As Glick points out, “league teams cannot operate successfully outside the league structure.”¹⁴ A team without a league is useless because it has no opponents; even if that team could find suitable opponents, however, the games produced would still lack many important features of league play: rule standardization, fair competition, a dedicated fan-base, and even, to some extent, monetary parity since many leagues also function as revenue-sharing sources. These tangible and intangible factors in conjunction with all the games created by the league fashioned a product different enough from “pickup games” that the league becomes the sole producer

of that product.¹⁵

If no two teams in the same league co-existed in the same city, this argument about the single entity status of sports leagues would be almost complete. As demonstrated above, the court system has for the most part recognized the right of sports franchises to control relocation of their teams, endorsing the single-entity status for such leagues.¹⁶ Since there are numerous instances, however, where two teams exist in the same city or where one team wants to move into a city already occupied by another team, the single entity argument is considerably more complicated. This complication arises because teams in the same region, unlike teams in the national market, do compete economically, and thus, preventing a team from moving into a market with an existing team may restrict competition. The court has acknowledged this difference, arguing that “rejection of a franchise application in the New York metropolitan area, for example, might require a different anti-trust analysis than” that of a franchise moving to an area with no current team.¹⁷ As Dale writes, a Sherman Act violation “has been found only where one team seeks to move into another’s territory.”¹⁸ The most important example of such a situation is represented

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by the set of cases developed around Al Davis and the NFL's Oakland Raiders who sought to move from Oakland to Los Angeles where the Rams already played but were blocked by the NFL. In its only strong contravention of a league's ability to restrict relocation, the court struck down the blocking act as anti-competitive. Its ruling is instructive because it provides arguments against considering the league as a single entity.

In *Oakland Raiders I*,¹⁹ the court argued that "for the purposes of antitrust litigation"²⁰ the National Football League was a collection of independent businesses and not a single entity. The court's argument was two-pronged: First, it argued that teams had independent value as producers and thus could not be considered one group; second, it concluded that, since two teams in the same league and in the same market do compete, any restriction of team movement might restrict inter-league competition between those independent businesses. Neither of the court's arguments is strong enough to disprove the single-entity of sports leagues.

In order to show that teams were independent businesses, the court argued that those teams could produce a product independently. One important pillar of the single-entity argument

is that league-based sports games are a unique product and that no one team is able to produce that product on its own. Essentially, the teams have no value outside the league, or at least a greatly-reduced value. The court implicitly advanced an argument against team dependence by finding that, although the league helped to produce games, its members acted together as a cartel rather than a single entity: "although the business interests of League members will often coincide with those of the NFL as an entity in itself, that commonality of interest exists in every cartel."²¹ The relation between the teams was not strong enough to find that they produced separate products.

The court also agreed with the plaintiffs that the NFL had a monopoly on the production of football games. First, the court defined the market for NFL football narrowly, asserting that only the local region around and including Los Angeles was the valid area under consideration. Within the definition of the market, a small region around a city, the NFL relocation restrictions seemed to grant each hometown team a complete monopoly since no other teams would be allowed into that market. "Exclusive territories insulate each team from competition within the NFL

market, in essence allowing them to set monopoly prices to the detriment of the consuming public.”²² Because each NFL team had a monopoly over its territory, blocking another team from moving into that area was an anti-competitive practice. The purpose of the “relocation guidelines and policies was to harm consumers by restricting output and thereby increasing profits”.²³ Thus the court found in the *Raiders* case that, the NFL’s blockage of the Raiders’ relocation was in violation of Section One of the Sherman Act.

The court’s decision in *Raiders*, however, suffers from three flaws which serve to undermine its determination that the NFL’s relocation restriction was an antitrust violation. The court defined the market incorrectly, found a monopoly where none existed, and presented an argument that contained logical inconsistencies. First, the court’s definition of the market as regional was unsupported by evidence. “It offered no indication that either interchangeability of products or cross-price elasticities were seriously considered in the deliberation.”²⁴ Such important economic considerations might have prevented the court from making its second decision, namely finding that NFL teams had a monopoly in their given market. Even if

the market were to be regional, there is evidence to suggest, at least in the *Raiders* case, that the NFL’s relocation rules do not simply grant and protect monopolies.²⁵

Finally, the court’s finding that NFL teams were independent organizations was inconsistent with their conclusion that the NFL had monopoly power of its territories. The court concluded that NFL teams could operate just as well outside the NFL (perhaps in another league) as in it because those teams were each separate business. There was “no conceptual reason why any NFL team could not decide to pull out and join a new league.”²⁶ But if the NFL had monopoly control of the football market, how could the team have the option to exist outside that league?²⁷ There would be no other option and the team would be worthless. It has already been shown that sports leagues do not monopolize their markets; however, this is a finding which at least supports the idea that teams have independent value.

Jeffrey Glick offers another strong legal argument about why a sports league should not be considered a single entity. Glick first argues that each team is an independent entity, because each team “is separately owned and operated with complete control

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over prices charged, marketing, strategy, and personnel.”²⁸ He further argues that the relation between a sports league and its teams is similar to that of the coalition of mattress manufacturers in the *United States v. Sealy* case. In that case, independent manufacturers formed a company on top of the individual entities, owned solely by the manufacturers. That company then allocated territory to each manufacturer and was found guilty of horizontally-restraining trade. Glick, however, errs on both arguments. Consider once more why a team cannot be considered a distinct economic entity: the product it produces is based on rules set out by the league, fans dedicated to the league, and other teams in the league. Second, a sports league does more than “license teams to produce the league product,”²⁹ as Glick correctly explains the *Sealy* manufacturers did. There is no league product without the teams and there are no viable teams without a league. This inextricably-linked relationship makes league-team interactions too complicated to fall under the category of “joint venture.”

The refutations of the *Raiders* case and Glick’s argument do not, however, address the fact that leagues may still compete economically to some ex-

tent. The next section will argue that, although sports teams from the same league may compete economically in the regional market, there are substantial benefits to consumers from single entity status. Section V will then address the anti-competitive harms which might arise from granting single entity status and, therefore, an antitrust exemption for relocation analysis.

IV. Pro-Competitive Effects of Single Entity Status

While the league should be considered a single entity because that designation best reflects the league’s economic structure, there are additional beneficial effects of single entity status. A single entity league, empowered to restrict franchise relocation, will benefit consumers of sports games, local governments, and the general public in four ways:³⁰ First, the single entity league will control the location of teams to preserve geographic diversity and franchise stability; second, such a league will encourage teams to invest in themselves, creating a superior product; third, the league will maintain competitive balance and fourth, the single entity league will control franchise expansion to prevent the dilution of team quality. The single entity league will take such steps because

they represent the best ways to promote interest and support for the league and its products.

First, a single entity league's concerns about the location of its teams will result in location decisions which benefit consumers of sports games and local governments.³¹ These benefits arise because the league will seek, out of its own self-interest, to preserve geographic diversity and franchise stability. Geographic diversity is important for two reasons. First, it ensures that the league can spread teams throughout all the major metropolitan areas making sure to saturate important markets. As a result of such saturation, the league is accessible to the most possible fans. Second, a fully-national product is more appealing to national television networks, who vie for the rights to broadcast league games,³² than a regional one. National television networks will broadcast more games nationally if the league's fan base is larger and national broadcast benefit all fans.

Franchise stability is even more crucial for league success than is geographic diversity.³³ First, franchise stability cements fan support by preserving the identification of place with team. Most sports franchises have deep roots in their communities and long histories.

Amoroso explains that a "sense of local pride"³⁴ develops from such team loyalty. These community connections and histories add an unquantifiable value to the franchises: The Boston Red Sox would certainly not draw the dedication and fanaticism they do currently if they relocated to Santa Fe.³⁵ The value of these unquantifiable assets is indicated by the NFL's retention of the rights to the Cleveland Brown's name and logo after that team moved to Baltimore.³⁶ Second, franchise stability preserves rivalry which drives much of the competition and interest in professional sports. One way to preserve these intangibly-beneficial rivalries is to prevent, through restrictions on franchise relocation, teams from moving cities simply to increase its individual profit at the expense of both the fans and the leagues.

Finally, franchise stability protects the league's credibility with local governments. These governments often spend huge sums of money to construct stadia and other sports facilities to entice teams to relocate to their markets. In addition to offering physical facilities, regions may offer large tax incentives for sports teams. After such an investment, argues the Chicago Legal forum, a relocation will be economically damaging.³⁷ Weiler explains that

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teams may even engage in bidding wars over a potentially-relocating franchise in the hope that the new team will increase economic prosperity.³⁸ An owner in one city, drawn to another city with the promise of a luxurious new stadium and ridiculously low tax policies, may move his team because of his own economic interest. But such a move erodes the confidence of cities in the league as a whole and may damage relationships with other teams in other cities.³⁹ When the Colts relocated to Indianapolis, explains Wesker, the move “provoked increased concern among mayors . . . over how to restore franchise stability.”⁴⁰ A sports league’s interest in team location is pro-competitive because it ensures consumers a better product and protects both the league and tax-payers from fickle owners.

Second, the league restriction of franchise relocation and preservation of exclusive territorial controls will improve the quality of the league games produced by the teams in those territory.⁴¹ When there is only one team in a given territory, that team has a large incentive to invest heavily in product development as well as to improve the general league reputation in its area. Dale agrees that such a territorial restriction does improve team quality as “limiting franchise relo-

cations forces team owners to develop the market for which such franchises were awarded.”⁴² Adding a second team to the environment may reduce the incentives of *both* teams to invest in product quality since they can each profit on developments made by the other. If one team strongly promotes the league, the other team benefits from the increased fan awareness as well.⁴³ This free-riding problem is of great concern to the league and to sports’ fans.

Lehn and Sykuta investigated the effects of the incentives for product quality in the *Raiders* case and found compelling evidence for the investment-incentives argument. They find a 36.5% and a 21.3% decrease in winning percentage of the Rams and Raiders, respectively, from the twelve-year period before the Raiders moved into the Los Angeles region with the Rams to the twelve-year period after the move (a twenty-four year time-span).⁴⁴ Not only is this finding consistent with the hypothesis that product quality should decrease, but the same data also indicated an *increase* in the winning percentage of the San Francisco 49ers as the Raiders moved further away from that team.

This finding is particularly important because standard microeconomic theory maintains that

companies with monopolies will resist innovation and let their product development stall as they enjoy monopoly rents. Under this standard assumption, procedures which strengthen the monopoly are anti-competitive, hurting the consumer with lower-quality goods and higher prices. In the case of sports games, however, the data suggest that a monopoly may lead to *higher* quality products, not lower quality ones. Thus, allowing the league to restrict franchise relocation allows a more-improved product for the consumer.

Third, a single entity league will maintain a competitive balance among its teams in order to preserve public enthusiasm and interest in the sport. Without such evenly-balanced competition, fans of certain teams will become demoralized with their teams and even the league itself. "Fans must believe that their team is a potential champion – i.e., that their team has a reasonable opportunity to win each game and also to compete for the championship" (Fisher, 201). This loss of revenue and support can be devastating to the team. The league already imposes several restrictions, such as a draft, on teams to ensure competitive balance. The most pro-competitive solution to distributing new talent would be to allow all teams

to bid on each player to allow the market to clear at its efficient price. Such a procedure, however, would skew competition to such an extent that league competition might become untenable.⁴⁵ The league's economic interests coincide with producing balanced, fair competition for fans.

Fourth, by restricting franchise expansion, the league ensures a higher-quality product for consumers.⁴⁶ Franchise expansion, a "cousin" of franchise relocation, refers to the creation of new franchises in previously unoccupied cities. Because each new team might earn its owner large profits before collapsing or might succeed enough to justify the initial investment while reducing the quality of the league, the league faces a large free-riding problem when considering the expansion of teams. First, the league will only allow the expansion if the new market is strong enough to successfully support a new franchise. Fisher argues that "the League must decide whether a community has the ability and the commitment to support" a team.⁴⁷ Making the move without the economic foundation would simply result in the failure of the team and a tarnishing of the league's reputation as producer of a high-quality product. Second, in any league with any type of revenue sharing

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program, an additional team or teams may thin out the common pool and hurt all teams. Such a thinning of the common pool might even hurt only the poorer, struggling team, an outcome which might be even worse. Fisher warns that “unlimited expansion might well cause the quality of the product to deteriorate.”⁴⁸ The league must have the authority to address such problems to protect the product for the fans from owners who are pursuing only their own economic interests.

V. Anti-Competitive Effects of Single-Entity Status

Although a league with single entity status for the purposes of relocation restriction will benefit consumers and local governments, such a league will have anti-competitive tendencies as well. A single-entity league may reduce consumer surplus and public utility by making economically inefficient decisions about team location, raising prices for consumers, and wielding arbitrary power. None of these dangers, however, outweighs the important benefits conferred by a single entity, antitrust exempt league.

First, relocation restrictions are economically inefficient because profit-maximizing owners will pick the most

efficient locations for their teams.⁴⁹ Owners should be able to choose any city they wish, moving freely whenever a better economic deal occurs. For instance, a city which offers a team a stadium and ten years of tax-free operation would be welcomed by an owner with open arms. Whatever generates the most profit per owner will be in the best interest of the league. Furthermore, a city and its fans would be able to vigorously compete for the teams they wanted. If a city held a great concentration of baseball fans, those fans could lobby for the city to steal away a strong baseball team. “If the objective is to protect the broader public welfare,” explains Weiler, “the ideal market test asks which city’s fans are willing to pay the most either to gain or to keep the current franchise free agent.”⁵⁰ By removing relocation restrictions, for example, by placing the leagues squarely under the purview of the Sherman Act, the government and the courts would create an efficient market place for the supply and demand of sports teams and, by extension, sports games.

The problem with leaving relocation decisions up to profit-maximizing owners arises from the externalities which occur in a league setting. Owners benefit immensely from the presence

of a league; in fact, this paper argues that the owner's team is practically useless without the league. The very fact that league teams generate their revenue by competing with each other, writes Wesker, demonstrates that "there is a unique and indispensable need for economic interdependence between members of professional sports leagues."⁵¹ The marginal benefit of this interdependence to an individual owner, however, is much greater than the marginal cost of being in a league. The owner considers only his own team and not the effects of his actions on others in the league and itself. According to Fisher, "the profit and loss calculus of particular teams do not fully take into account the costs and benefits to the league as a whole."⁵² A move by an owner may be economically beneficial to that team but it may unbalance competition, destroy regional diversity, and raise the ire of dedicated fans. The move makes sense to the owner because it increases profits but it adversely affects the league. The Chicago Legal Forum warns that "individual member teams may find it advantageous to vote against the best interests of the league in order to enhance their own welfare."⁵³ Relocation restrictions allow the league to compensate for the discrepancy between an in-

dividual team's marginal benefit and marginal cost for being in the league. There are certainly other methods of forcing marginal cost to equal marginal benefit; some of these are discussed in a later section of this paper.

Second, although relocation restrictions do increase product quality, they may also increase product price. If one team already exists in a city when another enters that region, stiff competition may develop over ticket prices as the new team tries to lure fans from the established team. The new team may try to undercut the old one, and vice versa, lowering prices for consumers of both teams. These lower prices would benefit fans by giving them more and more frequent access to games. This argument about lower prices, however, fails to take into account the inertia an established team already has and the importance of product quality. Teams already established in a city have long, deep histories to which their fans are drawn; generations may have rooted for the same team. Another team offering lower ticket prices may not draw away fans who don't go for "the game" but rather go for "the game played by my team." The quality of the team itself may be undercut by such competition as well. By offering lower ticket prices, teams

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reduce their profit margins and perhaps even their ability to pay for the best players.⁵⁴

Third, relocation restrictions are arbitrary because leaving relocation decisions in the hands of the league may result in the capricious use of power against unpopular owners. All leagues require at least a simple majority vote allowing a relocation but most require much more. Therefore, a large group of owners could simply veto any move by an owner they disliked, even if that move would be ultimately beneficial. This argument is ineffective, however, because it assumes that the owners as a whole would act against their own profit-maximizing interest. If an unpopular owner wished to make a league-benefiting move, it is unlikely that the move would be blocked. If the owner's move was beneficial to that owner but not the league as a whole, this paper has already provided ample arguments as to why that move should be blocked.

VI. Other Options and Solutions

Treating sports leagues as single entities for the purposes of franchise relocation restrictions makes legal and economic sense. By allowing the league to regulate the relocation of its teams,

the government and courts can best acknowledge the single-entity structure of the league, as well as the benefits to the public such as an antitrust restriction grants. But there are also other ways to regulate franchise expansion while keeping the public interest in mind. Fisher and Glick propose alternative measures a league itself can take, while Weiler⁵⁵ and Amoroso⁵⁶ call for stronger governmental resistance to team relocation. The next and final section of this paper will discuss other solutions to the relocation problem which, in some cases, would internalize the costs the league incurs when a team relocates. In addition, this section discusses some measures local and state governments may take to preserve the teams they already have and ones they may attract in the future.

What rules can the league adopt to mitigate the desire of franchises to relocate? Fisher proposes a simple solution: relocation fees. One major danger of allowing owners to determine their own locations is the costs of non-league-sanctioned relocation to the league and the other teams. Relocation fees would internalize this negative externality, forcing a team to consider the extra costs of such a fee. "The ability to charge such a fee, together with the super-majority rule, is in fact, a crucial feature of solv-

ing the externality and free-riding problems.⁵⁷ Such a relocation fee was used in the case of the St. Louis Rams. The Rams paid to move from California to St. Louis, satisfying both the league and the team owner.

In addition, each league could create its own relocation commission to consider the economic and social costs and benefits of each move. The recommendation of this commission might not be binding on the league commissioner or owners but it would force important issues which are not always discussed into the open. Such a report should consider, according to Glick, the population size of the target city, the population growth rate of that city, and that city's sports' tradition. In addition, the sports facilities present or offered should be weighed to fully consider the advantages and disadvantages of such a move.⁵⁸

City and state governments can also take steps to insure the presence of quality sports teams for their citizens. Most importantly, local governments must create and enforce strong stadium lease clauses.⁵⁹ If a team is tied to a long lease with large attrition clauses for leaving early, that team may be unable to relocate even if it had the support of the league. Although this method might

prevent relocations which might benefit the league as a whole and the team, it would still serve to protect consumers of sports. In the end, these consumers are the same ones whom the antitrust laws were originally designed to protect. Another more powerful and legally-suspect method for governments to retain their teams is the use of eminent domain laws. In the long battle over the Oakland Raiders, the city of Oakland won the court's approval to seize the Raiders under the "public use" doctrine of California's eminent domain law. The district court found that "no constitutional restriction, federal or state, purports to limit the nature of the property that may be taken by eminent domain."⁶⁰ Although it is unlikely that many governments will begin seizing teams, enough precedent exists to make the threat credible.

Finally, there is room for congressional bills to address relocation issues. One such bill, the Professional Sports Community Protection Act, granted leagues broad antitrust exemptions regarding relocation while requiring a codified, objective procedure for evaluating relocation attempts.⁶¹ These league and governmental alternatives should not be considered as replacements to the antitrust exemption which

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is a much more powerful measure; rather, these alternatives can be best viewed as complements to such an exemption mitigating the need for the league to wield its considerable power.

VII. Conclusion

The antitrust analysis of franchise free agency is complicated and the courts have not announced a clear policy for dealing with the questions of franchise relocation. Furthermore, the economic consequences of such relocations are both beneficial and harmful to consumers and the public in general. This paper has shown, however, that, for the specific purpose of considering franchise relocation restrictions, sports leagues should be treated as single entities. Such a designation most closely reflects the composition of the league as well as recognizes the great pro-competitive tendencies a league with such a status. Although such a designation will have some anti-competitive tendencies, the great boon granted to the public by a fully functioning system of competitive, national sports leagues is invaluable and such considerations must outweigh any dangers from market inefficiencies.

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¹ Breit, William and Kenneth G. Elzinga. *The Antitrust Casebook: Milestones in Economic Regulation.* Mason, Ohio: South-Western College Publishing, 2001, pp. 2.

² In several cases, including the *Seals* case, the product was determined by the court to be specifically sports games for *live audiences*. In most leagues, television contracts are negotiated by the league and for the league. There is little question about the antitrust implications of this policy, although the court did find against a version of this practice in *NCAA*. For the most part, this paper will not make such a distinction between live and televised games. The thrust of the arguments holds for both cases.

³“That product is a series of games in the context of a league season” (Fisher, 195).

⁴See the University of Chicago Legal Forum, pp. 258-60.

⁵See Ross, 538 and Dale, 345.

⁶*Los Angeles Memorial Coliseum Comm'n v. NFL*, 726 F.2d 1381.

⁷468 US 85. See The University of Chicago Legal Forum commentary of 2000, p. 258, footnote 75 for a further discussion of cases in which the courts have found a single-sport market. Also see footnote 78 for a discussion of other authors who argue that the relevant market is a single-sport one.

⁸Fisher, Franklin M.; Christopher Maxwell and Evan Sue Schouten. “The Economics of Sports Leagues and the Relocation of Teams: the Case of the St. Louis Rams.” *Marquette Sports Law Journal*, Spring 2000, 10 (2), pp.204.

⁹ Fisher, 203.

¹⁰Fisher, 196.

¹¹The “necessity” of using a smaller market definition has been recognized only in the *Raiders* cases. In that case, the NFL argued that a national market definition was the correct one, but the court disagreed, despite a considerable amount of evidence against the regional market designation.

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"The district court considered a substantial amount of evidence and listened to testimony from Commissioner Pete Rozelle and a number of NFL owners and officials about the relevant product and geographic markets involved. Nevertheless, the court concluded that market evidence, while important, should not become 'an end in itself'" (Amoroso, 302).

¹²Dale, Myron L and John Hunt. "Antitrust Law and Baseball Franchises: Leaving Your Heart (and the Giants) in San Francisco." *Northern Kentucky Law Review*, Winter 1993, 20 (2), pp. 356.

¹³*San Francisco Seals*, 379 F.Supp. 966.

¹⁴Glick, Jeffery. "Professional Sports Franchise Movements and the Sherman Act: When and Where Teams Should Be Able to Move." *Santa Clara Law Review*, Winter 1983, 23 (1), pp. 94.

¹⁵"A league structure creates a unique product" (Glick, 68).

¹⁶*NBA v. San Diego Clippers Basketball Club*, 815 F.2d 562., *Mid-South Grizzlies vs. NFL*, 720 F.2d 772.

¹⁷*Mid-South Grizzlies vs. NFL*, 720 F.2d 772.

¹⁸Dale, 356.

¹⁹*Los Angeles Memorial Coliseum Comm'n v. NFL*, 726 F.2d 1381.

²⁰Lehn, Kenneth and Michael Sykuta.

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²¹*Raiders I*, 726 F.2d 1381

²²*Raiders I*, 726 F.2d 1381.

²³Fisher, 199.

²⁴Lehn, 549.

²⁵"We first note that 15 years after the Raiders moved from Oakland to Los Angeles, no NFL franchise, including the Raiders, presently operates in the Los Angeles market. This observation is inconsistent with the view that NFL restrictions on franchise relocation simply protect monopoly rents of the local franchisees - if so, why did both the Ram and Raiders leave the Los Angeles market" (Lehn, 543).

²⁶ Lehn, 547-8.

²⁷"The notion that NFL football is a unique product seems absolutely at odds with the idea that teams have value independent of the league" (Lehn, 550).

²⁸Glick, 59.

²⁹Glick, 60.

³⁰In the *Raiders I* case, the superior court noted that the NFL failed to consider "factors such as fan loyalty and team rivalries" (726 F.2d. 1381). These factors, as well as some other more concretely economic ones, provide the strong arguments for allowing a league to function as a single entity even if its teams do compete against each other to some extent.

³¹Fisher, 206. Many of the arguments in this paragraph come from Fisher's excellent article "The Economics of Sports Leagues and the Relocation of Teams: the Case of the St. Louis Rams."

³²FOX's "Game of the Week," for instance.

³³League survival depends on a stable core of teams which remain in the same cities for a number of years" (Glick, 81).

³⁴Amoroso, Richard. "Controlling Professional Sports Team Relocations: the Oakland Raider's Antitrust Case and Beyond." *Rutgers Law Journal*, Winter 1986, 17 (2), pp. 286.

³⁵"Such tradition and devotion cannot be reproduced in a new city should the highest bidder spirit the team away unchallenged during a temporary decline in fortunes" (Dale, 361).

³⁶Fisher, 207.

³⁷"The relocation of well-supported teams obviously hurts home cities" (Chicago, 246).

³⁸A city's interest in attracting a sports team is selfish: the city believes the addition of such a franchise will increase commerce. This "spillover" effect is not, however, well supported by empirical evidence, implying that cities may cause themselves more harm than good by wooing teams (Weiler, 544).

³⁹Weiler, Paul C. and Gary R. Roberts. *Sports and the Law: Text, Cases, and*

Problems. St. Paul, Minnesota: West Group, 1998, pp.510

⁴⁰ (missing)

⁴¹Lehn and Sykuta devote a large section of their paper "Antitrust and franchise relocation in professional sports: an economic analysis of the *Raider's* case," to developing this argument about product quality. They state that one must consider "the implications of the territorial restrictions fo the individual teams' incentives to invest in product quality and the promotion of NFL football in their local market" (Lehn, 551).

⁴²Dale, 359.

⁴³Each franchisee chooses a level of investment that equates the marginal cost of its investment to the marginal revenue it receives from the investment" (Lehn, 555).

⁴⁴Both values are significant at the " = 0.1000 level. The San Francisco 49ers p-value was extremely significant at p = 0.0230. "The exit of the Raiders is associated with a substantial improvement in the quality of the 49er's product, which is again consistent with the argument that exclusive territories encourage investment in product quality" (Lehn, 559).

⁴⁵Consider the draft example. "If individual teams had complete autonomy in the hiring of players, rich owners or owners in more profitable cities would have an incentive to buy up the best players. This would be in their own interest, but it could reduce competitive balance and not be in the interest of the league as a whole, whose interests are aligned with those of consumers" (Fisher, 196)

⁴⁶"So far as the output market is concerned, the League can have no anti-competitive interest in preventing expansion to new locations" (Fisher, 206)

⁴⁷Fisher, 205.

⁴⁸Fisher, 206.

⁴⁹"It is rational to assume that any proposed move will constitute an attempt by the owner to increase profits by making his team more competitive in the marketplace" (Glick, 88).

⁵⁰Weiler, 542.

⁵¹Wesker, Mark Adam. "Franchise Flight and the Forgotten Fan: An Analysis of the Application of Antitrust Laws to the relocation of Professional Football Franchises." *University of Baltimore Law Review*, Spring 1986, 15 (3), pp. 572.

⁵²Fisher, 196. Also, "free riding occurs when a team benefits disproportionately from the actions of the league and its member teams, without compensating the League and the other teams for those actions" (Fisher, 209).

⁵³Chicago, 270. In this section, the author actually argues against leaving control in the leagues' hands because such a league may not function in a "model of optimal cooperation." The concern, however, should be mitigated by the large number of voting owners, who can work against one or two owners who do not have the league's best interest in mind.

⁵⁴Even leagues with salary caps can not escape this danger, because players already contracted can be signed to salaries irregardless of cap limits.

⁵⁵Weiler, 530.

⁵⁶Amoroso, 314-15.

⁵⁷Fisher, 211.

⁵⁸Glick outlines his plan, which has been summarized here, on pages 91-93 of his article.

⁵⁹Weiler, 530.

⁶⁰*City of Oakland v. Oakland Raiders*, 32 Cal.3d 60.

⁶¹Amoroso, 588.

A Dangerous Game: Prostitution and the HIV Threat in Vietnam

Matt Kozlov

Abstract

The following paper addresses the increasingly important issue of prostitution in Vietnam since 1986. With the rise of AIDS, the influx of tourism, and growing income inequality, the Vietnamese prostitution market is rising to the forefront of the nation's social evils. In this paper, the author applies microeconomic and rational choice analysis, in conjunction with a discussion of Vietnamese values, history, and current events, in an attempt to understand the forces affecting the supply and demand for commercial sex workers. Given this discussion, the author recommends policy changes to minimize the ills associated with prostitution.

I. Background

On April 30, 1975, the last US troops left South Vietnam, marking the end of a bitter, 30-year conflict.¹ The now reunified Socialist Republic of Vietnam, facing large human losses (approximately one million deaths according to the Population Council), internal party corruption, aging leaders, and the withdrawal of American military consumption, stood on the brink of economic disaster. The nation's invasion of Cambodia in 1978 further alienated it from the international community, and nearly every attempt at reform failed.² By

1986, annual inflation had reached 700 percent, and the State ran a record budgeted deficit.

When Vietnam's prime minister, Le Duan, died in July 1986, the sixth party congress enacted far-reaching economic and social reforms known as "Doi Moi" (meaning *economic renovation*). Press, religion, and arts all began to enjoy greater freedom as the state loosened its control. Similarly, the government encouraged civilians to report corrupt officials and agencies, and within a year the state was receiving 600 letters a month criticizing various authori-

ties.³ More importantly, the state officially recognized a private sector, encouraging profit-maximization, foreign investment, and foreign trade, in stark contrast to the isolationist, highly centralized, socialist system of state-owned industry employed up to that point.⁴ By 1989, the growth rate of Vietnam's output increased by a substantial 4 percentage points.⁵

Along with this transition to a market economy and less centralized government, however, came influx of Western culture, an increase in disposable income, and a greater cultural emphasis on material gain. Practices seen as undesirable effects of Western influences such as gambling, pornography, drug addiction, and prostitution grew significantly, and in 1996 the State began a \$16 million campaign known as The Campaign Against Social Evils in an attempt to control these practices.⁶

Of these "social evils," prostitution is perhaps the most important issue currently facing Vietnam. Prostitution in Vietnam first became widespread during America's military presence in the South, which consisted of 550,000 troops at its height.⁷ A service economy sprang up centered around American bases, and prostitution became highly visible. After reunification, the state

outlawed commercial sex, reducing prostitution considerably. Because prostitution is an underground economic activity, accurate figures are difficult to obtain. Estimates of the actual number of prostitutes in Vietnam today vary greatly. One 1996 estimate places the number at 70,000, while other estimates place the number between 200,000 and 500,000.⁸ The current population of Vietnam is estimated to be 78.5 million.⁹ More disturbing is the health of these prostitutes. In 1996, 5% of the nation's commercial sex workers were thought to be HIV positive.¹⁰ By February 2001, that estimate had risen alarmingly to 20%.¹¹

Although there is a considerable amount of sociological literature on prostitution, there are very few economic interpretations and even fewer economic interpretations specific to Vietnam. Thu-huong Nguyen-vo of the University of California, Irvine, wrote her dissertation on the consumption of sexual pleasures in a liberalizing Vietnam, but her paper discusses neither foreign consumption of sexual pleasures (i.e. sex tourism) nor the AIDS epidemic. Thanh-dam Truong conducted a study of sex tourism in Southeast Asia, but this study took place in 1990, before the HIV threat reached epic proportions,

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and it does not discuss Vietnam explicitly.¹² While, the International Labor Office released a detailed analysis of the economic and social bases of prostitution in Indonesia, Malaysia, Philippines and Thailand, it does not consider Vietnam.¹³

A growing market economy has facilitated prostitution from both the demand and supply sides. Because of the rising threat of HIV/AIDS, the State has adopted a strict anti-prostitution stance, which fails to address economic incentives effectively and instead promotes the spread of HIV.

II. Demand side

Demand for prostitutes in Vietnam comes two sources: tourists and natives, both of which have increased since the introduction of Doi Moi reforms. In the newly created market economy, formerly state-owned work units now have the autonomy to use resources to maximize profit. For example, many former bureaucratic offices have been converted into profit-making hotels and villas.¹⁴ Private businessmen, therefore, rely on state officials for lucrative contracts and cultivate these business relationships by taking them to locations known as *bia om*, establishments that serve alcohol, food, and

women who provide sexual favors.¹⁵ This form of “currency,” as Nguyen-vo indicates, allows state officials deniability (they are not committed to the private entrepreneur since they did not take money) and is invisible to anti-corruption accounting.

Conspicuous consumption of *bia om* has become a method of indicating wealth and power, a “performance of class” as Nugyen-vo calls it.¹⁶ In interviewing one young businessman’s mother, Nguyen-vo was told, “If you have money, you have to play. *Bia om* is a joy, a touch of class for men now-a-day.”¹⁷ Another stated, “Going for girls is a fashionable trend.... It’s a rich man’s fashion.”¹⁸

Prostitution in Vietnam, however, has also become a tourist attraction, and since the opening of the economy, tourism has skyrocketed. Since 1993, the number of foreigners visiting the country grew from 669,862 to 2,330,050,¹⁹ making tourism a \$1 billion industry. The state is also aggressively pushing to make Vietnam “a destination for the new millennium,” spending US \$18 million to attract 6 to 7 million foreigners to the nation by 2010.²⁰ Because of the illegality of prostitution and the subsequent lack of data, it is impossible to disaggregate these statis-

tics to determine what percentage of tourists frequent prostitutes in Vietnam. Using available data on neighboring Thailand (where prostitution is illegal but generally tolerated) as a rough proxy and representative of sex tourism in Southeast Asia, in the late 1980s, one sees that 73% of the total number of international tourists were male.²¹ While Southeast Asian countries don't necessarily intend to promote prostitution by encouraging tourism through macroeconomic policy, by developing an active entertainment sector to make the country a more attractive destination, the state unwittingly aids the development of prostitution. One economist writes, "it cannot be denied that government policies of support for tourism...spawned sex tours."²²

Interestingly, though, the introduction of foreign tourists into the Vietnamese prostitution market has amplified the domestic demand (Nguyen-vo 11). Seeking to distinguish themselves from tourists, native Vietnamese are trying to define "Vietnamese-ness" by embracing rural and folk ways, namely through the consumption of local cuisine and local girls (Nguyen-vo 11). Restaurants known for "eating and playing," advertising "hens with red claws" (a euphemism for prostitutes), are form-

ing on highways connecting rural locations rarely frequented by tourists (11). Here, natives can sample local delicacies and women, thereby asserting themselves as connoisseurs of Vietnamese society.

The structure of the demand schedule for Vietnamese prostitutes, however, remains undetermined. Without concrete statistics and data on customer's preferences and willingness to pay, little can be confidently asserted about the demand curve's shape except that, like the demand for any luxury good, it is downward sloping (as price falls, consumers want more). Additional research should be conducted to determine the price elasticity of demand for prostitution. If demand is fairly inelastic, then attempts to reduce the supply of Vietnamese prostitutes (current Vietnamese policy) will result in an increase in price but little change in the actual amount of prostitution.

It is likely, however, that price elasticities are different for foreign tourists and natives. The marginal value of a dollar to tourists, who generally are considerably better off than Vietnamese, is lower, so they are less likely to forego a transaction due to a price increase of a few dollars. Even among wealthy Vietnamese, the average annual income is

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roughly USD 2,400 (Nguyen-vo 8). Foreigners, however, make up less of the market, so not all transactions can occur at the \$20 level tourists are charged.²³ Most prostitutes have to settle for native “johns,” who generally pay \$1.80 to 2.70.²⁴

III. Supply Side

In a survey of prostitutes by the Vietnamese Center for Family and Women Studies, 70% cited economic reasons for entering their profession.²⁵ In another survey, 75.87% of the prostitutes interviewed stated that they were not ashamed of their acts and considered their decision to become a prostitute an informed choice.²⁶ The supply of prostitutes in Vietnam is highly responsive to economic conditions, which, because of rural poverty, unemployment, income inequality, gender inequality and changing values since Doi Moi reforms, have led to an increase in supply.

Although poverty levels have decreased significantly in Vietnam (the percentage of Vietnamese under the poverty level fell from 58% in 1993 to 37% in 1998), most of this progress has been made in urban centers.²⁷ Over 90% of those living in poverty live in rural settings, and 61% of rural workers are

currently under-employed (working less than 40 hours a week).²⁸ As a result of the developing rural-urban income gap, peasants are flocking to the cities in droves. As arable land decreases, and as population growth increases, many women find that there is nowhere to go but to the cities.²⁹ An estimated one million peasants, for example, crowded Ho Chi Minh City (formerly Saigon) in 1996.³⁰ Of the prostitutes surveyed in the VCFWS study, 70% came from rural locales.³¹

A woman will choose to become a prostitute if that profession affords her the highest utility (utility being a function of income and values) relative to all other professions. In an economic environment where one hour of work as a prostitute (\$1.80 serving domestic consumers) yields roughly the same as 10 hours of work as a male laborer, it is not surprising that women enter the prostitution profession.³² At times, in fact, prostitutes can earn up to \$400 from tourists for one hour of work, an amount that exceeds the per capita GDP of Vietnam, enough to support a family of 4 for a year.³³

The rising cultural value of profit and consumerism since Doi Moi, combined with the influx of Western culture has given rise to a loosening of sexual

mores. As one prostitute expounds: *While you work, you have motorcycles and clothes. When you go down the street, you see these beautiful girls who ride Dreams and Cubs [the best makes of motorcycles, a sign of money], with gold bangles on their wrists... You'd think they are of money. No. They are working girls like me... I think sometimes, I dress like this, I ride this kind of motorcycle, who'd know I'm a working girl?* (Nguyen-vo 7.)

This woman places considerable emphasis on material success, praising other prostitutes for their jewelry and consumer goods. Additionally, while premarital sex was once a taboo, it has now become more widely accepted among Vietnamese youth, particularly among urban dwellers.³⁴ Prostitutes, then, while still facing general disapproval, face less of an obstacle to market entry than they did in pre-Doi Moi times.

Doi Moi reforms, however, have also greatly increased the income inequality gap. In 1999 the richest 20% earned 7.3 times more than the poorest 20%, yielding a Gini coefficient (used to measure country's income inequality) of .410 (up from 1995's .350).³⁵ For reference, Sweden, considered a fairly egalitarian society, has a Gini coefficient of .250.³⁶ As a result, there

are more men in Vietnam desiring luxury items such as sexual consumption (as discussed earlier) and more women able to provide it.

Another significant factor contributing to the increase in willing prostitutes is the considerable amount of gender inequality. Female physical laborers, for instance, are systematically paid significantly less than their male counterparts. In salt mines, for example, women are paid one-fourth the amount earned by men (Thanh 184). In the North, rural women must work 16 hours a day during the harvest doing heavy, dangerous labor; they must then return to the family and do additional housework (185). One study indicates that female rural laborers work, on average, 11.5 hours a day for 302-336 days a year, while men, on average, work seven hours a day and 250 days a year (185).

Additionally, access to education for women is very poor, resulting in a 16% illiteracy rate (compared to a 7% illiteracy rate among men).³⁷ Dropout rates for women are also consistently higher than those of men. For instance, girls represent 48% of the pupils in first-level education, 37.5% of second-level education, and only 20.5% of tertiary education.³⁸ It is difficult, however, to discern whether the high dropout rates

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of women are causing an increase in prostitution or are, instead, a result of the increase. In other words, are more women becoming prostitutes because there are more uneducated women and a lack of well-paying jobs, or is prostitution becoming an increasingly attractive profession, resulting in more women foregoing their education to pursue prostitution? Because not all female drop-outs are becoming prostitutes, one can assume that there is another factor causing women to abandon their education. Some scholars point to the lack of opportunities for Vietnamese women with higher educations.³⁹

The opportunity cost, in other words, of an additional year of education is often too large, as women from an early age are expected to support the family both by supplementing household income and by performing household chores. For rural, impoverished women, especially, whose labor is essential to keeping the family fed, staying in school is an unaffordable luxury. As a result, some women drop out and become prostitutes to supplement family (and personal) income while some women drop out and become laborers.

IV. HIV

Unfortunately, prostitution car-

ries with it a fatal externality: the spread of HIV and AIDS. Over the past 5 years, as noted, the incidence of HIV among prostitutes increased from 5% in 1996 to 20% in 2001. By 2005, the UN Development Program predicts, 450,000 Vietnamese will be infected with the virus.⁴⁰ Although 65 percent of these infections are currently estimated to be drug related (a discussion beyond the scope of this paper), a thriving sex industry with diseased sex workers would cause the virus to spread significantly faster.

One of the obstacles to AIDS prevention among prostitutes is the general ambivalence towards the disease. As one social worker in Vietnam presses, "They think it's a disease God will send to you if you're unlucky. They think if they get HIV, they can live nine or 10 more years, but if they stop working, they and their families will die of hunger."⁴¹ Others take a more fatalistic view towards their lives and occupation. One woman states that "Because I've got no future I'm not afraid of catching AIDS and, anyway, all my clients prefer intercourse without contraception."⁴²

For many prostitutes financial concerns trump health concerns. Because many customers prefer sex without condoms, they are often willing to

pay more, and prostitutes are generally willing to accept the few extra dollars.⁴³ Similarly, many sex workers report requiring condoms with first-time customers while not requiring them of repeat customers.⁴⁴ One reason for Vietnamese prostitutes' lack of condom insistence is that they heavily discount the future, considering the few extra dollars now to be worth the risk of disease in future periods. Another reason is that many prostitutes are not fully informed as to the risks of unprotected sex.

Another problem facilitating the spread of HIV is that many prostitutes refuse to be tested. Some prostitutes fear the knowledge that such a test would bring, because it means both an early death and a moral responsibility to drop out of the industry - which most prostitutes refuse to do, as they are unwilling to sacrifice their income for a significantly lower paying unskilled job, the only kind for which most prostitutes are qualified.⁴⁵ Others refuse to take the test for financial reasons, as it would cost a woman approximately ten dollars.⁴⁶

V. Coping

Prostitution, a form of crime under Vietnam's current legal code, can be modeled as an economic, rational choice using standard microeconomic

theory. For this model, however, we must swap our conception of "supply" and "demand," redefining demand for prostitution as prostitutes' demand for "johns." When "turning a trick," economists theorize, a rational woman (we define rational as acting to maximize utility or welfare) analyzes the benefits and costs that trick carries, and she proceeds if the benefits outweigh the costs. The benefits include the income she receives from the transaction as well as any sexual gratification she may confer (to date, the author is aware of no studies indicating to what extent Vietnamese prostitutes derive pleasure from their occupation, but studies such as Peter Whittaker's The American Way of Sex indicate that many American middle class women who join the profession are simply "quite comfortable with their own sexuality and are pleased and amused to have parlayed their already liberated life-styles into absurdly high-paying jobs."⁴⁷

The costs include the money spent on clothes, jewelry, condoms (when applicable) as well as the opportunity cost of time spent (i.e., additional education, the next highest paying job, or leisure time), the potential loss of dignity, and the "expected punishment" of the crime. Punishment of prostitutes, according to Cooter and Ulen, is proba-

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bilistic.⁴⁸ A woman knows when turning a trick that, because of imperfect law enforcement she may not be caught, and, if caught, she may not be punished. Much as microeconomists calculate the expected value of various actions, prostitutes can calculate the “expected punishment” by weighting the potential punishment more heavily if the probability of capture is higher.

If we aggregate these individuals, we have a model for the prostitution rate, which, economists argue, can be used to decrease prostitution by increasing its cost (shifting the supply curve to the left, thereby reducing the equilibrium quantity of tricks). By increasing expected punishment, either by increasing the probability of capture or by increasing punishment (seeking to *deter* crime), the state can increase the cost of prostitution, which would result in a decrease in the rate of prostitution.⁴⁹ This is precisely what the state has done in its Campaign Against Social Evils.

Prior to the Campaign, enforcement of anti-prostitution laws was generally lax, but local police now have the authority to sentence prostitutes to a yearlong term at one of 53 mandatory rehabilitation/re-education centers without giving suspects due process.⁵⁰ While many officials are not above being

bribed,⁵¹ large numbers of prostitutes are sent to these camps annually. In the year 2000 approximately 1,000 prostitutes were sent to such camps from Ho Chi Minh City alone.⁵² At these camps, women are given classes on “dignity”⁵³ and AIDS education, they are given training in a skill of their choice (farming, sewing, making incense, raising silkworms, or hairdressing), and they are subjected to physical labor.⁵⁴ By raising the punishment and likelihood of capture, the government attempted to shift the supply curve inward but with only marginal success. According to one massage parlor owner, the prostitution market has just become more hidden, stating that “I’ve had to completely redo the whole place... people making real money now are the people who make screens and curtains.”⁵⁵

These reeducation camps, while considered punishment by prostitutes, are nevertheless well intentioned. Recognizing poverty as the primary reason women enter the prostitution market, the State, by giving women skills, is attempting to increase the opportunity cost of turning tricks. If the state can raise the value of prostitutes’ next-best alternative, they reason, the cost of prostitution rises, the supply curve shifts inward, and prostitution rates decrease. Unfor-

unately, however, the camps seem to have a marginal impact. Most women upon leaving these camps simply return to the street, as the potential earnings of streetwalking far surpass those of the jobs taught in the camps.⁵⁶

The Campaign's most significant effect, regrettably, is that prostitutes are now forced further underground, making condom access and AIDS education considerably more difficult. Fearing capture and the loss of a year's income, prostitutes are less likely to seek medical aid, AIDS education, and free condoms offered by international humanitarian groups such as FHI and UNAIDS. Similarly, establishments that support prostitution, such as restaurants, hotels, and disco bars refuse to accept condom donations, as that would be tantamount to officially admitting the presence of prostitution, a punishable offense under the Campaign.

The Campaign, by approaching prostitution as a "social evil," a moral aberration, and a Western pox responsible for the HIV epidemic,⁵⁷ conflates two problems. Although HIV is spread through unprotected commercial sex, the two problems are not, per se, directly linked. In Nevada, where many counties have legalized brothels, mandating condom use and health checks,

100% of prostitutes strictly require their customers to use protection, and there is zero incidence of HIV.⁵⁸

Were Vietnam to legalize prostitution, requiring all prostitutes to register and submit to regular health checks, issuing "licenses" to uninfected women, diseased prostitutes would be driven out of the business. In addition, this would then create an additional source of taxable revenue, which could then be used to fund AIDS education, HIV testing, and condom distribution. This policy would improve the market, as information flow would advance. Brothels, in an effort to demonstrate the health of their prostitutes and attract customers, will have an incentive to provide AIDS education, HIV testing, and condoms. In Indonesia, for example, where prostitution is legal, two women in a Dolly brothel were found to be HIV positive.⁵⁹ Soon after, 785 women in the brothel volunteered to have their blood tested (385 more than the Health Department had planned to collect), announcing publicly that if the WHO was not willing to pay for the tests, they would do so personally.⁶⁰ This brothel, desiring to attract (or win back) business, had an incentive to prove that AIDS was not an issue. Were Vietnam to legalize prostitution and improve information flow,

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market forces would ensure that diseased prostitutes (akin to “lemons”) would receive no business.

Another approach Vietnam should consider, especially if further research shows demand for prostitutes to be inelastic, would be policies that shift the demand curve inward. If demand is inelastic and supply elastic, as posited, then changes in supply will have little effect on the amount of prostitution. Changes in demand, however, will have a significant effect on the quantity of prostitution (see Appendix). One policy affecting demand would be propaganda campaigns announcing the high HIV rate among prostitutes and the danger of AIDS. This essentially raises the “expected punishment” of the consumer, as this campaign would raise both his perceived probability of being medically punished and the severity of the punishment, decreasing demand.

Similarly, one could raise the customer’s expected legal punishment. Currently, if a customer is caught in the act, he must pay fines. If he is a State official, his office is notified, he is often demoted, and his misdeed is often made public.⁶¹ If he is a common citizen, however, “he shall be handed back to the local administration, and he shall be made to pledge not to commit again.”⁶²

In other words, he is slapped on the hand. Tourists, however, are largely exempt from punishment. Continuing the State’s firm anti-prostitution status, were the State to raise the punishment for customers, demand would decrease significantly. Because the opportunity cost of a year in prison is higher for a well off consumer (which “johns” tend to be in Vietnam) than for a prostitute with little to lose, such a policy would have a significant effect on the demand schedule. This decrease, in turn, would decrease the price of a “trick,” reducing the incentive for women to turn to prostitution.

VI. Conclusion

While current prostitution policy in Vietnam recognizes the socio-economic factors that cause prostitution, it does little to address them. The effects of education camps are dubious at best, as the individual rewards from job training pale in comparison to the financial rewards gained from prostitution. As long as there are men willing to pay for sex, and as long as poverty encourages young women to provide sex for money, there will be a market for prostitution. By forcing the industry underground, however, participants are more prone to diseases such as HIV, as they are less

likely to seek medical aid, education, and protection. Legalizing the industry, however, would allow medical monitoring (which, through newly taxable income, could pay for itself). Overcoming the State's socialist, strongly anti-prostitution stance, however, is in all likelihood, an insurmountable obstacle.

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