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A 7-POINT PLAN FOR DEVELOPMENT-FRIENDLY REFORM

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ABSTRACT. The governance system that the current process should design must be based on representative institutions, not on any G, which will always face problems of legitimacy. This process should place at the center of the debate the discussion of voice and representation of developing countries in international economic decision making and norm setting. The global recession now under way calls for a strong policy response. This means clear expansionary monetary, credit and fiscal policies in all industrial countries.

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1. The Process and the Institutional Design that It Develops Must Be Inclusive

The financial crisis has shown how dysfunctional the current global financial architecture is for managing today's global economy. The need to govern globalization has never been clearer, but at the same time the present institutional arrangements have never been so impotent. Calls for deep reforms and even for a second Bretton Woods Conference are, therefore most welcome. Similar calls for reform were made after the Asian and Russian crises, which engulfed most of the developing world in deep recessions, but they led at best to marginal reforms. The fact that this time the industrial countries are at the center of the storm may lead them into action, but it also creates the risk that measures of direct interest to developing countries will be marginalized from the agenda.

There are also two fundamental problems with these calls for reform. The first is that they lack scope: most proposals relate to macroeconomic action to counter the world recession (including helping developing countries counter strong external shocks) and to regulatory reform. In both cases they are largely confined to national policies rather than to reform of the global architecture. Most of the issues presented in this paper are left out of the agenda. Second, the process started the wrong way, by excluding most countries from the

table. It is obviously good for major industrial countries to show leadership, but no fundamental reform can take place if it is not enacted in an inclusive process. History has shown that crises represent opportunities to redraw old arrangements – even in radical ways.

It is important for major countries to show leadership. This now includes major developing countries. However, a desirable reform process must give voice to industrial and developing countries alike, and to both large and small countries. So, the major objective of the reform process is not to replace the G-7/G-8 by another G. The G-20 is certainly better in this regard, but it is still an ad hoc arrangement in which major developing countries (e.g., Nigeria), major industrial countries (e.g., up to very recently Spain), and most particularly, medium and small-sized countries are unrepresented.

This also means that the governance system that the current process should design must be based on representative institutions, not on any G, which will always face problems of legitimacy. And it is necessary, for the same reason, to involve the United Nations, the most representative global institution, perhaps by taking the step, recommended in the past by many, of creating a Global Economic and Social Council in the United Nations, with effective powers of coordination over the system of global economic and social governance. Such a body would have to be based on a constituency system that takes into account the different weight of nations, such as that on which the International Monetary Fund (IMF) and World Bank boards are constituted (with significant redefinition in the way these “weights” are measured), rather than on the “one country one vote” system on which the UN is built. The UN Financing for Development process could become the institutional framework from which to launch a participatory process leading to such reform of the global financial architecture, with the backing and close collaboration of the United Nations, the Bretton Woods Institutions and the Bank of International Settlements (BIS).

This process should, furthermore, place at the center of the debate the discussion of voice and representation of developing countries in international economic decision making and norm setting, as mandated by the Monterrey Consensus approved in the 2002 UN Conference on Financing for Development. This includes not only the IMF, the only place where some (though extremely modest) reforms have been adopted, but also the World Bank (where

such discussion is in place), the Bank of International Settlements, the Basel Committee on Banking Supervision, the Financial Stability Forum and other world regulatory bodies.

2. A Coordinated Global Macroeconomic Policy Package Must Be Adopted

The global recession now under way calls for a strong policy response. This means clear expansionary monetary, credit and fiscal policies in all industrial countries. Europe has lagged behind in all these dimensions relative to the US and Japan. Developing countries should also be part of the solution, and should adopt equally expansionary policies. The fact that many of them have accumulated large amounts of foreign exchange reserves in recent years, and have lower external and public sector debts than during previous crises, implies that they do have more maneuvering room to adopt expansionary policies than in the past.

However, the strong retrenchment of private capital implies that support from multilateral institutions (the IMF and multilateral development banks) as well as bilateral development cooperation would be crucial to facilitate counter-cyclical policies in the developing world. The major problem is the scale of such financing. According to the Institute of International Finance, emerging markets will face net negative private credit flows of US\$30 billion in 2009 vs. net positive flows of US\$632 billion in 2007. International Financial Institutions will only add US\$28 billion in financing (i.e., about 4 percent of the shortfall!). So, a major initiative to increase the availability of multilateral financing is required which, as I argue below, should be based on a major counter-cyclical issue of Special Drawing Rights (SDRs). The G-20 took the right steps in the direction of reactivating SDR issuance and increasing multilateral financing. However, in the case of the IMF, additional financing will rely on “arrangements to borrow”, which is the least desirable of all available mechanisms; increased quotas and allowing unutilized SDRs to finance additional IMF lending are much better in this regard.

Multilateral financing – and additional ODA in the case of poor countries – is particularly important for those countries that have more limited room to maneuver, due to the imbalances accumulated during the previous boom, the capital outflows and/or the collapse in

their terms of trade. But this means that it is essential to avoid the IMF conditionalities of the past, which forced developing countries to adopt contractionary macroeconomic policies during crises. The composition of the policy packages is also essential, both in terms of the monetary/fiscal mix as well as the relative size of packages adopted by different countries. The strong balance sheet adjustment and associated financial deleveraging taking place in the private sector of the industrial world, and particularly in the United States, means the demand for credit by private agents may be weak, even if the health of the financial sector is restored. This enhances the need for expansionary fiscal policies. To the extent that tax benefits are likely to be saved rather than spent, public sector spending policies are also clearly preferable.

Furthermore, industrial and developing countries with external surpluses should lead the way in adopting expansionary policies. Relying excessively on the expansionary policies of the world's major deficit country, the United States, runs the risk of igniting (or, rather, reigniting) fears of disorderly adjustment to global imbalances, which would add another highly undesirable dimension to the current crisis – or abort an eventual US-led world economic recovery. More generally, relying on an export-led recovery is highly undesirable in the face of the ongoing collapse of international trade, as it may encourage already visible protectionist pressures in many countries. The most undesirable outcome of the current crisis would be repeating, even in weaker forms, the “beggar thy neighbour” policies that magnified the effects of the Great Depression.

The IMF should be placed at the center of global macroeconomic policy coordination. This is the only way to provide a clear institutional structure for such coordination and to give developing countries a voice on the associated processes. Indeed, the current crisis provides the opportunity to put the IMF back at the center of global macroeconomic policymaking, as its original design envisioned. Such coordination has tended to take place outside the Fund since the breakdown of the original Bretton Woods arrangements in the 1970s, including in recent decades through the role assumed – in a very weak form, anyway – by the G-7. The multi-lateral surveillance of global imbalances launched by the Fund in 2006 was an interesting step in that direction, but it lacked binding commitment by the parties and an accountability mechanism.

3. The Regulatory Deficit of Global Finance Must Be Corrected

The magnitude of the current crisis is clearly associated with inadequate regulation and supervision of financial activities. Since the Asian crisis, it was accepted that financial liberalization must be accompanied by stronger prudential regulation and supervision. This principle was applied in many parts of the developing world but was entirely disregarded in the US, where further liberalization was accompanied by deregulation and weak supervision of financial intermediaries.

The discussion on regulation must start by agreeing on basic regulatory principles. The first principle is that regulations should have a strong counter-cyclical focus, thus avoiding excessive indebtedness (leverage) and forcing financial institutions to accumulate increasing capital, provisions (reserves) and liquidity cushions during booms. Absolute limits on leverage should be part of the solution. This also implies that, when pricing assets according to their market value to maintain transparency, the system must have mechanisms (such as counter-cyclical loan-to-value ratios) to avoid asset price bubbles from feeding into the credit expansion, and asset price busts from feeding into the credit squeeze.

Regulations must also be comprehensive, to avoid the massive loopholes through non-banking intermediation that led to the current turmoil, and that has in fact been central to the increased systemic leverage during booms that preceded financial meltdowns in many countries. This will also include regulating the types of transactions that led to the current crises, particularly securitization and derivatives, and will force all the markets to be open and transparent and thus limit over-the-counter operations. Systemically important financial intermediaries must be subject to particularly harsh supervision, and perhaps to stronger regulatory standards. Reliance on the internal models of financial institutions, the major focus of Basel II, should be discarded. It has already shown how perilous it can be, and how the use of similar risk models by financial institutions can lead to greater instability.

To these principles we must add other, well-established ones: consumer protection, restricting monopoly power (a major issue looking forward, as private finance is experiencing rapid concentration), and encouraging portfolio diversification. Suffice is it to say

that even these well established principles were not followed in recent years. The first of these functions should be considerably enhanced to avoid the supply of toxic mortgages and highly risky investment vehicles offered to unsophisticated agents during the recent boom in many countries.

Creating a single world financial regulator is probably not viable or, for that matter, desirable, given different regulatory traditions around the world. So, the system that is designed in this area should be based on a well functioning network of national and regional authorities (still missing in the EU) and should include truly international supervision of financial institutions with a global reach (such as the college of supervisors proposed by the G-20). The IMF should not be at the center of the regulatory system. The BIS and the Basel Committee are better placed, but this would require a fundamental reform to broaden (preferably universalize) their membership and address two major problems that the Basel Committee has faced in recent years: the lack of representation of developing countries – a problem that has now been partly corrected by extending its membership to all G-20 countries – and the capture of regulation by large multinational banks. Clear accountability mechanisms would also have to be introduced in all regulatory bodies, both national and international.

4. The International Monetary Fund Should Be Revamped

Four essential reforms of the IMF should be part of the agenda. The first, as pointed out, is placing this institution at the center of global macroeconomic policy coordination. The second is creating a meaningful and truly global reserve currency. The third is improving the crisis response effort. The fourth is a more active use of capital account regulations. The IMF was created on the basis of the dual gold-dollar system (the so called “gold-exchange standard”). This system collapsed in the early 1970s and was replaced by one based on fiduciary dollars, and secondarily on competing fiduciary reserve currencies – i.e., on the use of a national currency (or national and regional currencies) as a global currency. This system is inequitable and unstable. It is inequitable because it forces a transfer of resources from developing countries to the developed nations that provide reserve currencies – a transfer that has actually increased through time due to the realization by developing countries that “self-pro-

tection” in the form of large foreign exchange reserves is the only defense they can rely on in a world of acute financial instability.

The system is also unstable because it is plagued by cycles of confidence in the US dollar, when the US alternatively adopts expansionary policies – reflecting the fact that the system does not impose firm macroeconomic discipline on the reserve issuing country – followed by contractionary policies, which may help restore the credibility of the dollar as a reserve currency. During both phases of this cycle, policies of the reserve currency country are adopted without consideration as to their international impact. A system based on competing reserve currencies would not solve the inequities and instability of the current system and – to make matters worse – would add another one: the instability of exchange rates among major reserve currencies. Indeed, this problem is already partly present in the current system.

The inequities and instability of current arrangements is why the world monetary system should be based on a truly global reserve currency: a fiduciary currency backed by the central banks of the world. This is what was hoped for when the SDRs were created in the 1960s. This process must be completed, by either transforming the SDRs into such a global currency or by creating a global reserve asset that could be used in at least some private financial transactions. Among other advantages, this system would provide a mechanism for the IMF to play a more active role during crises, by issuing SDRs in a counter-cyclical way. Indeed, a large counter-cyclical issuance of SDRs is the best mechanism to finance large official support to developing countries during the current crisis. This would be the global equivalent to what the US Federal Reserve Bank has been doing on a massive scale since September, expanding lending to the private sector by more than one trillion dollars (with more to come under current policies) – with no consideration as to whether this is consistent in the long run with the role of the dollar as a global reserve currency. This has not been a major problem in the short run, due to both “flight to quality” and the transfer of resources to the US to cover the withdrawal of funds from financial intermediaries that is taking place as a necessary part of the ongoing deleveraging process.

The third issue is the need for the IMF to lend during balance of payments crises rapidly and without the overburdening conditionalities of the past, particularly when the sources of the crises are rapid

reversals of capital flows or sharp deteriorations in the terms of trade. This means putting in place a preventive credit line for capital account crises and making resources available in adequate magnitudes to compensate for adverse terms of trade shocks. This implies that the IMF would act more like a central bank, providing liquidity in an agile way, the way central banks have actually been providing funds in industrial countries on a massive scale in recent months. Positive steps in this direction were adopted by the IMF on 24 March 2009, particularly the creation of the Flexible Credit Line for crisis prevention purposes, the considerable expansion of other credit lines and the major reform of conditionality (relying more on ex-ante conditionality and eliminating structural performance criteria). It remains to be seen whether the Flexible Credit Line would be actively used (its two predecessors were not). This line also runs the risk of unduly dividing developing countries into two categories: those with good policies and those with bad, which entails significant additional risks for the latter. As indicated, the financing for such liquidity could be a large counter-cyclical issue of SDRs.

The current IMF agreement does not commit countries to capital account convertibility and thus leaves them with full autonomy to adopt capital account regulations, either to restrict excessive capital inflows during booms or to control capital flight during crises. The evidence of strong linkages through which both financial euphoria and panic are transmitted worldwide indicates that it would be wise to make more active use of capital account regulations. The Fund should be encouraged not only to tolerate but actually to advise countries on what regulations to impose under given circumstances. Indeed, the regulatory structure that must be developed to manage financial stability in the global era should include provisions that apply to cross-border capital movements, such as: generalized reserve requirements on cross-border flows, minimum stay periods, and prohibitions to lend in foreign currencies to economic agents that do not have revenues in those currencies.

5. A Counter-Cyclical Role for Development Cooperation Should Be Fully Utilized

A large increase in Official Development Assistance (ODA) to low income countries can play an important role, not only to combat poverty but also to contribute to the generation of aggregate demand

at the global level. Meeting existing ODA commitments (which will face strong competing fiscal demands in industrial countries) but also making additional aid available is particularly important to counter contractionary policies in the poor countries in the face of a deterioration in their terms of trade due to a collapse of commodity prices.

Past crises have also shown that multilateral development banks (MDBs) can play an essential role when private financing dries up. The major problem, as we have seen, is the scale of their resources. So, a major initiative to increase the resources available to multilateral development banks is crucial. Additional capital injections are one solution. Another is to allow these banks to benefit from the counter-cyclical issue of SDRs, by authorizing the IMF to buy MDBs' bonds (or investing part of the SDRs received by industrial countries in such bonds).

Crises, including the current one, have also shown that one particularly problematic issue that developing countries face is the curtailment of commercial credit available to exporters, which then becomes an additional contractionary effect and severely limits an essential mechanism through which deficit countries can recover from crises. So, the launching by MDBs of a large scale program of commercial lending, such as that proposed by the World Bank, should be at the center of the crisisresponse efforts. MDBs can also play a role in risk mitigation by operating as "market makers" for innovative instruments, such as GDP and commodity-linked bonds, and move fully (or even completely) into lending to developing countries in the national currencies of recipient nations.

6. An International Debt Court Must Be Created

The lack of a regular institutional framework to manage debt overhangs at the international level – i.e., a court similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding – is one of the major deficiencies of the current international financial architecture. The only regular institutional mechanism in place is the Paris Club, which deals exclusively with official financing. The system has relied in the past on ad hoc mechanisms, such as the Baker and Brady Plans of the 1980s and the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiatives (MDRI) since the mid-1990s, or on traumatic indi-

vidual debt renegotiations. The problem with all these mechanisms is that they have generally come too late, after high indebtedness has had devastating effects on countries. This is also true of the Paris Club, due to its traditional reliance on sequential debt rescheduling, which again means that countries are left with debt hangs for excessively long periods. The system is also inequitable, as it does not treat all debtors or all creditors with uniform rules. Even Paris Club creditors regularly complain that private lenders do not follow their agreements. Unilateral renegotiations can also lead to an unfair treatment of borrowers depending on their weight and influence.

The discussion of the new international financial architecture should solve this problem by creating an international debt court to serve both as mediator and eventual arbitrator of both public and private sector international loans and bond issues. Privately-run restructuring mechanisms, based on the active use of collective action clauses, are clearly insufficient, as debtors would delay using the mechanism to avoid antagonizing creditors, debtors would not be uniformly treated, and there would not be a uniform treatment of official and private creditors. Any workout mechanism that is developed has to start with defaults by debtor countries, which would then trigger negotiations. And the system must be based on the principle of a “fresh start”, allowing borrowers to make a (relatively) swift return to markets. Furthermore, active use of multilateral development bank lending and guarantees could play a role in supporting such a return to markets.

7. The System Must Rely More on Regional Institutions

In all of the areas of reform, the global architecture should rely more broadly on regional institutions. Indeed, in a heterogeneous international community, the creation of networks of global, regional and national institutions will provide a better system of governance than arrangements based on single global organizations. This is based on old federalist principles: regional and sub-regional institutions give stronger voice and sense of ownership to smaller countries and are more likely to respond to their demands. In some areas this is recognized today, such as in the system of multilateral development banks, where the World Bank is complemented by regional development banks and, in some parts of the world, sub-regional and interregional banks.

Applying the system of networked institutions is particularly urgent in the monetary area, where the IMF should make more active use of regional institutions, such as the Chiang Mai Initiative or the Latin American Reserve Fund, and support their creation in other parts of the developing world. Indeed, the IMF of the future should be seen as the apex of a network of regional reserve funds – that is, a system closer in design to the European Central Bank or the Federal Reserve System than to the unique global institution it currently is. Similar institutional design could be adopted for prudential policies and for the international debt court.

Developing countries are in an excellent position to contribute to this task, given their large foreign exchange reserves. Using those reserves more actively for swap arrangements among central banks, pooling them in reserve funds, or using them to support the development of regional bond markets are all mechanisms to multiply the room to maneuver that they provide. These reserves and existing sovereign wealth funds could also be used to create or capitalize multilateral development banks owned by developing countries, and to invest in bonds issued by such institutions. The multiplication and growth of sub-regional development banks and inter-regional banks owned by developing countries are one of the most fertile grounds for South-South cooperation – though an underexploited one.

NOTE

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THE GROWING INFLUENCE OF ECONOMICS AND ECONOMISTS ON ANTITRUST: AN EXTENDED DISCUSSION

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“Over the years, our courts have increasingly turned to economic principles to guide their interpretation of the antitrust laws... Relying on economic analysis is now routine for U.S. courts in the antitrust arena – a salutary development helping our courts make sound decisions... Another area where economics has a profound impact is within the Antitrust Division...” (Barnett 2007)

ABSTRACT. Over the past two to three decades economics has played an increasingly important role in the development of U.S. antitrust enforcement and policy. This essay first reviews the major facets of U.S. antitrust enforcement and next reviews the ways in which economics – starting from a low base – has grown in importance in antitrust. The essay then highlights three antitrust areas in which the influence of economics has had the greatest influence: merger analysis, vertical relationships, and predatory pricing. The essay concludes with the identification of four antitrust areas where further economics analysis could have high returns.

JEL: K21, L40, L41, L42

1. Introduction

Antitrust policy in the United States is an interesting amalgam. There is, of course, a body of legislated law, starting with three important statutes: the Sherman Act of 1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914.

Next, because the language in these statutes is extraordinarily broad and terse (at least by modern legal standards), more than a century of numerous legal decisions by courts have interpreted and given specific meaning to the broad language of the statutes.

Further, decisions by the federal enforcement agencies – the Antitrust Division of the U.S. Department of Justice (DOJ), and the Federal Trade Commission (FTC) – as to whether to pursue cases or to decline their prosecution¹ provide another facet to antitrust policy.

Finally, economics and economists also play an important role (Kovacic 1992; FTC 2003; Barnett 2007). In principle, the antitrust laws – at least in their modern interpretation² – are intended to encourage competition and to thwart cartels/price-fixing and to discourage the unwarranted creation and exercise of market power (which is often paraphrased as “monopoly power”). Competition and monopoly have been bedrock concepts in the liturgy of microeconomics for over a century. Therefore, the influence of economics on antitrust policy would seem to be a natural phenomenon.

As this essay illustrates, however, the influence of economics on antitrust is a relatively recent phenomenon; it was not considered to be so “natural” as recently as three or four decades ago. As of the early 1960s, for example, the two enforcement agencies had few well-trained economists on their staffs, and the appearance of an economist as an expert in support or testifying on behalf of the plaintiffs or defendants in antitrust litigation was rare. Today, by contrast, both agencies have sizable staffs of well-trained economists, and most antitrust cases of any kind have economists involved on one or both sides. Indeed, in response to this “demand”, a number of specialty antitrust economics consulting firms have arisen to offer a “supply”.

The rest of this essay will expand on these developments, as follows: In Section II we will provide a brief overview of the antitrust laws. Section III will trace the growth of the influence of economics and economists over the past century. Section IV will pay special attention to three areas on which economics has had the most influence – merger analysis, vertical restraints, and predatory pricing. Section V offers a brief conclusion and highlights some areas where further economic analysis could still yield high returns.

2. A Brief Overview of U.S. Antitrust Policy

There are three major thrusts to modern antitrust enforcement in the U.S.:³ First are the efforts to prevent “collusion”: explicit price fixing or bid rigging or cartel formation.⁴ These efforts mostly consist of law suits brought by the DOJ and by private parties under Section 1 of the Sherman Act, which forbids “every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States or with foreign nations...” Violations of the Sherman Act are felonies, which means that the DOJ can seek jail terms against individuals and sizable fines against companies. Private

parties that claim to have been harmed directly by price-fixers can also bring suits (regardless of whether there have been any suits by the DOJ or FTC), with any proven damages being automatically trebled.

Second are efforts to prevent mergers, where their effect would be to cause a significant lessening of competition. These are primarily suits brought by the DOJ or the FTC under Section 7 of the Clayton Act, which forbids mergers “where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.” The goal of such a suit is simply to gain an injunction to stop the merger from proceeding.⁵

Third are efforts to restrain the unilateral exercise of market power by a seller (or a buyer). These are suits that can be brought by the DOJ, the FTC, or private parties. Section 2 of the Sherman Act (under which suits by the DOJ and private parties are authorized), forbids acts that “monopolize, or attempt to monopolize... any part of the trade or commerce among the Several States, or with foreign nations...” Again, the Sherman Act allows felony convictions, although the DOJ more often brings civil suits that seek injunctions in this area. And, again, private treble-damages lawsuits can be brought.

In addition, the FTC has, under the auspices of Section 5 of the Federal Trade Commission Act, the ability to prevent “unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce.” And, finally, the DOJ, the FTC, and private parties can bring suits aimed at tying, bundling, exclusive dealing, and similar vertical restraints under the auspices of Section 3 of the Clayton Act, which forbids efforts “to lease or make a sale or contract for sale of goods ... within the United States ... or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods ... of a competitor or competitors ... where the effect ... may be to substantially lessen competition or tend to create a monopoly in any line of commerce.”

In addition to prosecuting antitrust law violations, the DOJ and the FTC pursue pro-competition policies in three other, less well known ways: First, they frequently file “amicus” (friend of the court) briefs in privately filed antitrust cases that have reached appellate levels, especially cases reaching the Supreme Court. Since the number of private cases filed annually is approximately ten times the number of cases brought by the two enforcement agencies (Viscusi et al. 2005, p. 72), and private cases can yield legal precedents that are as binding as

agency-filed cases, these amicus briefs give the agencies the opportunity to “lobby” the courts in favor of pro-competitive decisions.

Second, the DOJ and FTC engage in “competition advocacy”: the advocacy of pro-competitive policies for other federal agencies in regulatory proceedings and for the 50 states in their regulatory actions. For example, in the past few years both the DOJ and the FTC have been urging the states (with only partial success) to eschew regulatory policies that would protect “full-service” residential real estate brokers from the competition offered by “discount” brokers.⁶

Third, as other countries (especially in the wake of the transition of Eastern European countries to market-oriented economies) have become more interested in developing antitrust policies of their own, the two U.S. enforcement agencies have provided international advice and technical assistance.

3. Economics and Economists’ Involvement in Antitrust – A Brief History⁷

The influence of economics on antitrust has occurred along three paths: (a) advances in economics thinking – as expressed in theoretical developments and empirical testing – about the microeconomics that undergirds antitrust; (b) the direct involvement of economists in antitrust litigation and policy development at the enforcement agencies and in the service of private parties that have been plaintiffs or defendants in antitrust cases; and (c) economists’ writings about specific antitrust cases, including those in which they provided litigation support. This section will trace these three paths.

A. The Development of Economics Thinking

Prior to the 1930s it would be difficult to identify a body of economics thought that could be identified as “industrial organization” (IO).⁸ By the end of the 1930s, however, the field was starting to coalesce and take shape.⁹ Partly this was due to the influence of Edward Mason at Harvard (Mason 1939, 1957) and his colleagues and Ph.D. students¹⁰ (who included, in the 1930s and afterward, Donald Wallace, William Nichols, Jesse Markham, Merton J. Peck, Samuel Loescher, Richard Tennant, James McKie, Joe Bain, Carl Kaysen, Morris Adelman, Donald Turner, and Richard Caves), and partly this was due to the

industrial data collection and analyses that emerged from the Temporary National Economic Committee (TNEC).¹¹

The field continued to develop over the next few decades. By the 1950s the structure-conduct-performance (S-C-P) model – with the central role of seller concentration as a determinant of industry conduct and performance – was the mainstay of IO thinking. In addition, formal thinking about oligopoly (e.g., Chamberlin 1929, 1956, ch. 3; Fellner 1949, Stigler 1964), aided by insights from game theory (e.g., Shubik 1959; Schelling 1960) and especially the “prisoner’s dilemma”, helped support the central role of concentration. The role of entry in the model gained prominence in the 1950s (Bain 1954, 1956). Empirical testing of the relationship between industry profit rates as a dependent variable and structural characteristics of the various industries as the independent variables, using the *Censuses of Manufactures* as the central data source, provided empirical support for the model (Bain 1951), as did a large number of industry study monographs.¹² By the end of the 1950s, Bain’s (1959) IO text laid out the S-C-P paradigm in systematic form, while the Kaysen and Turner (1959) treatise on antitrust provided an extensive application of the paradigm to antitrust.¹³ It is noteworthy that Kaysen and Turner’s strong structuralist deconcentration remedies for oligopolistic industries rested heavily on Bain’s (1954, 1956) finding that economies of scale, though a significant barrier to entry in many industries, did not appear to extend to the sizes of the largest firms in these industries – with the implication that antitrust-forced divestitures would involve little or no sacrifice in productive efficiencies.

It is important to mention that a second strand of IO analysis was developing in the 1950s, under the intellectual leadership of Aaron Director (Peltzman 2005). This strand was more skeptical of the S-C-P paradigm, more sympathetic to vertical restraints, and generally more supportive of market outcomes. The economics scholars that were associated with Director included Milton Friedman, George Stigler, Sam Peltzman, Lester Telser, Harold Demsetz, John McGee, Ward Bowman, and Meyer Burstein.

Government antitrust victories, and the judicial opinions that supported those victories, in Sherman Section 1 and Section 2 cases in the 1940s and 1950s involving the aluminum industry, the cigarette industry, the movie industry, and the shoe machinery industry reflected these developments of the S-C-P paradigm. Only in the movie industry, however, were there major divestitures as remedies – but these involved

vertical separations, not the horizontal divestitures envisioned by Kay-
sen and Turner.¹⁴

Further, after being largely dormant because of unduly restrictive wording in its original legislative language, Section 7 of the Clayton Act was revived by the Celler-Kefauver Amendment in 1950. A remarkable two-decade series of government challenges to mergers – mostly victorious – followed, based largely on S-C-P grounds (although some elements of populist fears of bigness were also present).¹⁵

The 1960s and early 1970s saw further elaborations of the S-C-P paradigm and more extensive testing of the profitability-concentration relationship, with the inclusion of entry conditions (e.g., Mann 1966; Comanor and Wilson 1967; Collins and Preston 1968, 1969; Weiss 1971),¹⁶ advertising (e.g., Comanor and Wilson 1967, 1974), foreign trade (e.g., Esposito and Esposito 1971), the structural conditions on the buyers' side of the market (e.g., Lustgarten 1975), risk (e.g., Bothwell and Keeler 1975), and the presence of a critical concentration ratio (e.g., White 1976).¹⁷ But a "Chicago School" counter-revolution was brewing as well, which argued that high concentration might be causing high profit rates, because of economies of scale (contrary to the earlier claims by Bain).¹⁸ The famous "face-off" of the S-C-P advocates versus the Chicago School in the early 1970s led to the publication of a widely read and cited conference volume (Goldschmid et al. 1974).

A further blow to the profit-concentration empirical support for the S-C-P model came in the early 1980s, from two major attacks (Benston 1982; Fisher et al. (1983); Fisher and McGowan 1983; Fisher 1984, 1987) on the use and reliability of the accounting data that were used to measure the profit rates used in the studies and on whether relative profit rates were even the appropriate indicators of market power. Profit-based tests of the S-C-P paradigm quickly tailed off, but were soon replaced by price-based studies drawn from individual industries (e.g., as summarized in Weiss 1989; Audretsch and Siegfried 1992), which tended to show a similar positive relationship between prices and concentration. In addition, empirical studies of auctions indicated that the number of bidders at auctions (which, say, in procurement auctions would be an approximate equivalent to the number of sellers in a market) would have the same type of effect on prices (e.g., Brannman et al. 1987; Brannman and Klein 1992).

As is discussed in Section IV below, the S-C-P paradigm, with some further economics-based supplements, became the basis for much

of the modern version of the DOJ (and now DOJ-FTC) “Merger Guidelines”.

In the area of vertical relationships, too, there was a clash between the “Harvard” tradition and the “Chicago” tradition. The former was suspicious of – and tending to hostility toward – vertical mergers (e.g., between suppliers and customers) and vertical restraints (e.g., tying, bundling, exclusive dealing, territorial sales restraints, resale price maintenance). As will be discussed in Section IV, until the early 1970s antitrust legal decisions were generally hostile toward vertical mergers and vertical restraints, but since then the line of economic reasoning that was championed by the Chicago School has generally prevailed in the courts.

Finally, it is worth noting that a number of IO-oriented professional economics journals came into existence, providing specialized vehicles for the dissemination of the research in IO. Included in this list (with their first year of publication) would be: *Journal of Industrial Economics* (1952); *Antitrust Bulletin* (1955); *Journal of Law & Economics* (1958); *RAND Journal of Economics* (1970);¹⁹ *Review of Industrial Organization* (1977);²⁰ *International Journal of Industrial Organization* (1984); *Journal of Regulatory Economics* (1984); and *Journal of Economics & Management Strategy* (1992). Also, a first-ever *Handbook of Antitrust Economics* (Buccirossi 2007) is another milestone in the maturation of economics thought as applied to antitrust.²¹

B. The Role of Economists at the Enforcement Agencies and in Antitrust Litigation

Economists’ direct involvement in antitrust extends back at least to the beginning of the twentieth century,²² although their role prior to the 1970s was often limited to simple litigation support – in a sense, as “hewers of wood and haulers of water” – rather than being able to participate in the development of case theories and the formulation of policy.

The U.S. Bureau of Corporations, which had been established in 1903 within the Department of Commerce and Labor and which had economists on its staff, provided valuable research support for some of the early antitrust prosecutions undertaken by the DOJ, including *U.S. v. Standard Oil Co.*, 221 U.S. 1 (1911), and *U.S. v. American Tobacco Co.*, 211 U.S. 106 (1911) (Scherer 1990). An early – possibly, the first – testimony by an economist in an antitrust case was in *U.S. v. United*

States Steel Corp., 223 F. Rep. 55, 251 U.S. 417 (1920), which was filed in October 1911 and ultimately decided by the Supreme Court in 1920 against the DOJ. The Supreme Court's decision disparagingly cited the testimony of "an author and teacher of economics whose philosophical deductions had, perhaps, fortification from experience as Deputy Commissioner of Corporations and as an employee in the Bureau of Corporations." (251 U.S. 417, 448)

When the FTC was created in 1914, its Economic Department (later to become the Economic Division and then the Bureau of Economics, which is the title it retains today) inherited the Bureau of Corporations' research and investigative role, as well as absorbing the specific office accommodations and personnel of its predecessor agency (Scherer 1990).²³

At the DOJ the responsibility for antitrust enforcement was placed in a separate division – the Antitrust Division, where that responsibility still rests – only in 1933.²⁴ Within three years the Division hired its first economists (White 1984). Until the early 1970s, however, the economics group within the Division was used primarily for data gathering and statistical support in litigation. Posner's (1971, p. 532) study of the Division offered the following description: "...the Division's economists today are handmaidens to the lawyers, and rather neglected ones at that." Another study of the Division in the early 1970s (Green 1972, p. 128) characterized economists there as "...second class citizens. They have little or no say in the type of cases brought, the legal theories used, or the relief sought. In general, they neither conduct long-range studies nor work closely with the policy-planning staff. Mostly they aid attorneys in the preparation of statistical data for trial, and they occasionally testify. They are technicians – 'statisticians,' as nearly all of the lawyers call them – and act like it." A later study (Weaver 1977) mentioned economists only in passing – again an indication of their subsidiary role.

In the mid 1960s the Assistant Attorney General for Antitrust, Donald Turner (who had a Ph.D. in economics from Harvard as well as a law degree), established the position of Special Economic Assistant to the Assistant Attorney General, and a number of young industrial organization economists – William Comanor, Oliver Williamson, William G. Shepherd, H. Michael Mann, Leonard Weiss, Kenneth Elzinga, George Eads, and George Hay – served one-year terms in the position.²⁵ But, until the early 1970s, little was done to strengthen the

quality and position of the staff economists at the Division, as reflected in the descriptions above.

At the FTC the tradition that had started at the Bureau of Corporations served economics and economists somewhat better. The Bureau of Economics (BE) was able to attract Ph.D.-trained leaders, such as Corwin Edwards, John Blair, Jesse Markham, and Willard Mueller, and during the 1960s the size and budget of BE expanded considerably (Mueller 2004). Nevertheless, at the end of the 1960s outside reviews of the FTC (ABA 1969; Green 1972) commented unfavorably on the low quality of BE's personnel and on BE's lack of influence on policy and decision-making within the agency.²⁶

Two top-level committee reviews of general antitrust policy at the end of the 1960s viewed economics and economists quite differently. The "Neal Report" (White House 1968) was largely silent on the subject, although it did endorse improvements in the gathering of economic information by the enforcement agencies. The "Stigler Report" (Task Force 1969), on the other hand, strongly endorsed an expanded role for economics and economists at the Antitrust Division and at regulatory agencies more widely.

The 1970s brought a general strengthening of the position of economists at the two enforcement agencies and in antitrust litigation support.²⁷ At the FTC a reorganization and reform of the agency strengthened the position and status of BE. During the decade H. Michael Mann, F.M. Scherer, Darius Gaskins, and William Comanor served as BE Directors. Commentaries at the end of the 1970s (Katzmann 1980; Clarkson and Muris 1981) noted the strengthened position of BE. At the DOJ in 1973 George Hay, completing his one-year term as Special Economic Assistant, convinced the Division to strengthen the Economics Section and transform it into the Economic Policy Office, with Hay as its initial director and with authority to expand its personnel and recruit Ph.D. economists to staff positions (Kauper 1984).²⁸

More generally, the 1970s saw an increased involvement of economists in antitrust cases; sometimes the economists' involvements led to publications that reviewed the economic issues of the specific cases in which they had been involved. These writings will be discussed below.

The involvement of economists in antitrust policy, as well as litigation support, took a sharp turn upward in the early 1980s, with the arrival at the Antitrust Division and the FTC of leaders who were quite

sympathetic to the role and message of microeconomics in the development of antitrust policy and in litigation.²⁹ For the first time there were FTC Commissioners who were economists, including the Chairman during the first few years of the Reagan Administration. The FTC continued to have an economist as at least one of its five commissioners during 1981–1985 and 1991–1995. At the Division, an indication of the rising importance of economists in the mid 1980s was the elevation of the position of Director of the Economic Policy Office to a Deputy Assistant Attorney General.

As of the first decade of the twenty-first century, economists continue to play prominent roles at both agencies (see, e.g., FTC 2003; Barnett 2007; Salinger et al. 2007; Carlton and Heyer 2007). At the DOJ, there are approximately 60 Ph.D.-level economists, headed by a Deputy Assistant Attorney General who is usually a leading academic IO economist and who typically serves for about two years in the position. Similarly at the FTC, the BE is staffed by approximately 70 Ph.D.-level economists (although about a quarter of their time is spent on consumer protection issues), and the Bureau Director is usually a leading academic economist who spends about two years in the position.

C. Economists’ Writings about Specific Antitrust Cases

The tradition of economists’ writing specifically about major antitrust cases extends at least as far back as a 1949 symposium in the *American Economic Review* (Adelman 1949a; Nicholls 1949); Nicols 1949)³⁰ and includes Stocking and Mueller’s (1955) discussion of the “cellophane fallacy” of *U.S. v. E. I. du Pont de Nemours & Co.*, 118 F. Supp 41 (1953), 351 U.S. 377 (1956). Most of the antitrust discussions prior to the 1970s were by economists who had simply become interested in the details and implications of a particular antitrust case. A notable exception was Carl Kaysen, who in 1950 as a Ph.D. student of Edward Mason’s at Harvard provided a unique form of antitrust litigation support: He was appointed as a law clerk by Federal District Court Judge Charles Wyzanski, to provide economic counseling to Judge Wyzanski in the DOJ’s monopolization trial of the United Shoe Machinery Company.³¹ Kaysen served for two years and wrote a lengthy report for Judge Wyzanski, which subsequently became Kaysen’s Ph.D. dissertation and a monograph (Kaysen 1956).

By the 1970s economists were actively participating in antitrust cases more frequently and then writing about those cases.³² Such instances in cases that were initiated in the late 1960s and the 1970s included Fisher et al. (1983), DeLamarter (1986), and Houthakker (1999) on the DOJ's monopolization suit against IBM; Brock (1989) on private suits against IBM; Evans (1983) and Noll and Owen (1994) on the DOJ's suit to break up AT&T; Hay (1999) on the FTC's suit against the manufacturers of lead-based antiknock gasoline additives; White (1975) on the DOJ's suit alleging price-fixing of fleet automobile sales by General Motors and Ford; Schmalensee (1978) and Scherer (1979) on the FTC's investigation of the breakfast cereal industry; Hilke and Nelson (1989) on the FTC's allegations of predation in the sale of coffee; Dobson et al. on the FTC's suit concerning du Pont's monopoly of titanium oxide (1994); Cox (1989) on a private suit challenging state-imposed restrictions on advertising by lawyers; Elzinga (1999) on a private suit alleging conspiracy and predation by Japanese manufacturers of televisions; Preston (1994) on a private suit challenging territorial restraints by GTE-Sylvania; Warren-Boulton (1999) on a private suit alleging resale price maintenance by Monsanto; and Lynk (1999) on a private suit alleging tying by Jefferson Parish (Louisiana) Hospital.

Since the 1970s economists' participation in antitrust litigation has become substantially more frequent (Kovacic 1992; Barnett 2007), and articles reflecting that participation also continue to appear (see, e.g., Kwoka and White 1989, 1994, 1999, 2004a, 2009).

4. Special Achievements

There are three areas of antitrust where economists' achievements in bringing changes in antitrust enforcement and policy are especially noteworthy: merger analysis, vertical relationships and restraints, and predatory pricing.³³ Each will be addressed below.

A. Merger Analysis

Almost all of modern antitrust merger analysis takes as its starting point the DOJ-FTC *Horizontal Merger Guidelines*.³⁴ The Guidelines, first published in 1982³⁵ and subsequently revised in 1987, 1992, and 1997, establish two approaches under which a merger might be deemed to

have anti-competitive consequences: “coordinated effects” and “unilateral effects”.

1. Coordinated effects. This is a direct application of the S-C-P model, with the special emphases that were provided by Stigler (1964). The primary concern under this approach is that oligopolistic sellers will, post-merger, be able implicitly to coordinate their behavior so as to achieve significantly higher prices (or to effect other changes in conduct variables) and higher profits. Seller concentration, as measured by the Herfindahl-Hirschman Index (HHI),³⁶ occupies the center stage (as it does in the S-C-P model) for at least two reasons: First, seller concentration is surely the most readily measured structural attribute; and second, the immediate effect of any horizontal merger is to increase seller concentration. The Guidelines indicate specific guideposts as to post-merger concentration (and merger-induced changes in concentration) that will likely trigger close scrutiny and possible intervention.³⁷

The Guidelines also bring into the analysis the other important components of the S-C-P model: conditions of entry; the buyer side of the market; the nature and complexity of the product; the transparency (or opaqueness) of price and other market information; and the antitrust history of the sellers in the market.

A particular problem of implementing merger enforcement prior to 1982 had been the issue of defining the relevant product and geographic markets. The S-C-P model assumes that an appropriate market has been specified, so that the *market* shares of the leading firms provide a meaningful indication of the likelihood that the firms will collectively exercise market power. But the S-C-P model itself provides no guidance for delineating appropriate markets.

The Guidelines addresses this problem in the following way: A relevant market is defined as a product or group of products that are sold by a group of sellers who, if they acted in concert (i.e., as a “hypothetical monopolist”), could achieve a “small but significant and nontransitory increase in price” (SSNIP); that SSNIP is designated as 5% for one year. This is equivalent to defining a relevant market as one in which market power can be exercised (or one in which market power can be enhanced).³⁸ The smallest group of sellers that satisfies the SSNIP test is usually designated as the relevant market. These principles apply to the determination both of product markets and of geographic markets. The determining factor in the analysis is whether sufficient numbers of buyers would switch away to other sellers (of

other goods and/or located in other areas) so as to thwart the price increase.

The logic of this approach follows from the goal of preventing mergers that create or enhance market power. The SSNIP test identifies the smallest group of sellers who could exercise such power. With one exception, the market definition paradigm focuses on sellers (since it is sellers who exercise market power). That exception arises when a group of sellers may be able to practice price discrimination and raise prices significantly for an identifiable group of buyers (defined by a geographic area or by a business function). In such a case, that group of buyers may also be considered to be a relevant market.

This market definition paradigm has proved enduring and has spawned a “mini industry” of econometric efforts in merger cases to estimate “critical” demand elasticities and price-cost margins that would indicate the boundaries of relevant markets.³⁹

2. Unilateral effects. The 1992 revision to the Merger Guidelines added “unilateral effects” as a second area of anti-competitive concern with respect to mergers. By this is meant a significant post-merger price increase that could occur solely on the part of the merged entity. This unilateral price increase could occur if the two merging firms produced products that were moderately close substitutes for each other (but not perfect substitutes) and a significant number of the customers of each firm had as their runner-up choice the products of the merger partner. If the products of all other firms were a distant enough third choice for these customers, then the merged entity would likely find a general price increase worthwhile (Ordoover and Willig 1993) – and could do even better if it could identify and target these “trapped” customers and thereby practice selective price discrimination against them.⁴⁰

Note that the anti-competitive effects of this type of merger do not arise because of cooperation or collusion among the firms that compete with the merged entity. Instead the competitive harm occurs because the merged firm is better able to internalize the benefits of a price increase.

Note also that for the unilateral effects analysis the issues of market definition and market shares are largely irrelevant, since what matters is the extent to which customers have the two merging firms as their first and second choices (and the extent to which other firms are a distant third choice). Thus, direct measurements of elasticities and cross-elasticities are crucial; and, again, a mini-industry of empirical estimations for antitrust purposes has arisen.⁴¹

B. Vertical Relationships and Restraints⁴²

As was noted above, the “Harvard” IO tradition was hostile toward vertical relationships and vertical restraints. The important Kaysen and Turner (1959) antitrust treatise, for example, had a generally negative view of vertical mergers and of vertical restraints such as tying,⁴³ bundling, exclusive dealing, requirements contracts, full-line forcing, territorial restraints, and resale price maintenance (RPM).⁴⁴ Earlier, the *Report of the Attorney General’s National Committee to Study the Antitrust Laws* (1955), which included economists Walter Adams, Morris Adelman, John M. Clark, Alfred Kahn, Eugene V. Rostow, Sumner Slichter, and George Stigler,⁴⁵ as well as a number of leading antitrust lawyers and law professors, showed a similar harsh view of vertical restraints.⁴⁶

“Chicago”, however, under the intellectual guidance of Aaron Director, began offering a different view of vertical restraints. Bowman (1957) and Burstein (1960a) argued that tying was often a vehicle for monitoring the buyers’ use of the tied product and thus serving as an alternative mechanism for effecting price discrimination (about which the welfare effects are generally ambiguous); Burstein (1960b) argued the same for full-line forcing.⁴⁷ Telser (1960) argued that RPM could be a means by which a manufacturer (or other “upstream” entity) could overcome the potential free riding problems that accompany the provision of product information to customers and thereby induce more point-of-sale service from retailers.⁴⁸ The free riding argument for RPM has been extended to the provision of other retailer services (Mathewson and Winter 1984; Marvel 1985; Marvel and McCafferty 1984, 1985, 1986). And free riding problems have been offered as a justification for territorial restraints (White 1981) and for exclusive dealing (Marvel 1982). Further, there was a widespread “Chicago” attack on the idea that vertical integration could generally have serious anti-competitive consequences.⁴⁹

Prior to the mid 1970s, the Supreme Court’s antitrust legal decisions with respect to vertical restrictions and vertical mergers were consistent with the harsh “Harvard” view. Early on, the Court condemned RPM as a per se violation of Section 1 of the Sherman Act in *Dr. Miles Medical Co. v. John D. Park and Sons Co.*, 220 U.S. 373 (1911).⁵⁰ This decision was subsequently reaffirmed in *U.S. v. Bausch & Lomb Optical Co.*, 321 U.S. 707 (1944); *U.S. v. Parke, Davis & Co.*,

362 U.S. 29 (1960); *Simpson v. Union Oil Co.*, 377 U.S. 13 (1960); and *Albrecht v. Herald Co.*, 390 U.S. 145 (1968).⁵¹

Tying came under attack in *Motion Picture Patents Co. v. Universal Film Manufacturing Co.*, 243 U.S. 502 (1917);⁵² *United Shoe Machinery Corp. v. U.S.*, 258 U.S. 451 (1922); *Carbice Corp. v. American Patent Development Corp.*, 283 U.S. 27 (1931); *International Business Machines Corp. v. U.S.*, 298 U.S. 131 (1936); *Morton Salt Co. v. G.S. Suppiger Co.*, 314 U.S. 488 (1942); and *International Salt Co. v. U.S.*, 332 U.S. 392 (1947). In 1949 the Court condemned tying as a per se illegal offense in *Northern Pacific Railway Co. v. U.S.*, 356 U.S. 1 (1949), and declared that “Tying agreements serve hardly any purpose beyond the suppression of competition,” *Standard Oil Co. of California et al. v. U.S.*, 337 U.S. 293, 305-306 (1949). This onslaught on tying continued in *U.S. v. Loew’s, Inc.*, 371 U.S. 38 (1962); *Atlantic Refining Co. v. FTC*, 381 U.S. 357; *FTC v. Texaco*, 393 U.S. 223 (1968); and *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U.S. 495 (1969).

Similarly, the Court attacked requirements contracts in *Standard Oil Co. of California et al. v. U.S.*, 337 U.S. 293 (1949), and in *Richfield Oil Corp. v. U.S.*, 343 U.S. 922 (1952). Earlier, the Court had attacked exclusive dealing in *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346, and repeated that attack in *Standard Oil* (1949) and in *FTC v. Motion Picture Advertising Service Co.*, 344 U.S. 392 (1953). Later, in *U.S. v. Arnold Schwinn & Co. et al.*, 388 U.S. 365 (1967), the Court condemned territorial restraints as a per se violation of the Sherman Act.⁵³

And the Court condemned vertical mergers in *U.S. v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586 (1957); *Brown Shoe Co. v. U.S.*, 370 U.S. 294 (1962); and in *Ford Motor Co. v. U.S.*, 405 U.S. 562 (1972).

The tide turned after the mid 1970s,⁵⁴ with “Chicago” arguments largely carrying the day. In 1977 two important decisions showed the change in direction. In *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977), the Court declared that territorial restraints should be examined under a rule of reason, rather than being automatically condemned as per se illegal under the rule of *Schwinn* just 10 years earlier. And in *United States Steel Corp. v. Fortner Enterprises, Inc.*, 429 U.S. 610 (1977), the Court found (reinforcing *Jerrold*) that the absence of market power in the tying market meant that a tying arrangement was acceptable (despite the per se rule of *Northern Pacific*, which remained in place).

The 1980s saw further progress. Though the Supreme Court continued its per se condemnation of RPM in *Monsanto Co. v. Spray-Rite Corp.*, 465 U.S. 752 (1984), and in *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988), it raised the standard of proof that plaintiffs would need to provide in order to prevail. In *Jefferson Parish Hospital District No. 2 v. Edwin G. Hyde*, 466 U.S. 2 (1984), the Court again found that the absence of market power meant that a tying arrangement was acceptable; and a minority opinion signed by four members of the Court argued that the per se rule for tying should be superseded by a rule of reason approach.

In the 1990s, the Court took a step back on tying, in *Eastman Kodak Company v. Image Technical Services, Inc.*, 504 U.S. 451 (1992), in which the Court (on a motion for summary judgment) found that Kodak must stand trial on a tying claim. However, later in the decade, in *State Oil v. Khan*, 522 U.S. 3 (1997), the Court declared that maximum RPM should be judged under the rule of reason (and not condemned as a per se violation, as had been decided in *Albrecht*).

The first decade of the twenty-first century has been auspicious in this respect. In *Illinois Tool Works, Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006), the Court decided that the presence of a patent on the tying product does not automatically mean that the seller has market power. And in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007) the Court decided that minimum RPM – the “plain vanilla” version of RPM that had been condemned as per se illegal in *Dr. Miles* – should also be judged under a rule of reason.

In sum, antitrust law with respect to vertical restraints (as interpreted through Supreme Court decisions and DOJ and FTC enforcement decisions) has made great progress since the 1970s, building on the advances in economics thinking discussed above. Challenges to vertical mergers are rare, as they should be.⁵⁵ Most vertical restraints are judged under a rule of reason; and even judgments concerning tying, which is still nominally a per se violation, are at least requiring a showing of market power. Where vertical restraints involve abuses and enhancements of market power, as in *U.S. v. Microsoft*, 253 F.3d 34 (2001), and *U.S. v. Dentsply International, Inc.*, 399 F.3d 181 (2006), prosecutions occur and succeed, as they should.⁵⁶ And, with luck, in the not too distant future, the Supreme Court will see the wisdom of formally reversing *Northern Pacific* and judging tying cases under the rule of reason as well, completing the movement from the harsh judicial

treatment of the 1960s to a more balanced view of vertical relationships and vertical restraints – based on sensible economics.

C. Predatory Pricing

Prior to the 1970s, the “treatment of predatory pricing in the cases and the literature ... has commonly suffered from two interrelated defects: failure to delineate clearly and correctly what practices should constitute the offense, and exaggerated fears that large firms will be inclined to engage in it.” (Areeda and Turner 1975, pp. 697–698) Similar defects could be ascribed to allegations of price discrimination (where predation claims were often also lurking, implicitly if not explicitly), as exemplified by FTC enforcement actions and Supreme Court decisions (e.g., *Utah Pie Co. v. Continental Baking Co. et al.*, 386 U.S. 685 (1967)). Common to enforcement actions and judicial decisions were findings of “pricing below cost” as incriminating behavior, where “below cost” was either vaguely defined or defined as below average costs (which usually also meant using some arbitrary method of distributing joint costs across multiple products, such as using the relative sales revenues of the products as the relative weights).

Academic work to clarify predatory issues, and to cast doubt on the empirical frequency of predation, began at “Chicago” (under Aaron Director’s influence) in the late 1950s.⁵⁷ The paradigm of envisioning predation as an “investment” (an initial sacrifice) and then a subsequent recoupment period (higher prices permitting a profits return on the initial investment) became clear. Building on this base, Areeda and Turner (1975) offered a powerful critique⁵⁸ and a proposal that pricing at or above marginal cost (with average variable cost serving as a proxy for the usually unmeasurable marginal cost) should generally be considered as a “safe harbor” for firms in alleged predatory situations. This subsequently became known as the “Areeda-Turner rule.”⁵⁹

Subsequent legal decisions and especially Supreme Court decisions – in *Matsushita Electric Industrial Corp., Ltd., et al. v. Zenith Radio Corp., et al.*, 475 U.S. 574 (1986);⁶⁰ *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, U.S. (1993);⁶¹ and most recently in *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.* 127 S. Ct. 1069 (2007) – have clearly been influenced by the investment-plus-recoupment paradigm and by the price-above-marginal-cost test.⁶²

It is worth noting that, at about the same time that economists in the antitrust area were clarifying notions of predation, economists in re-

gulatory areas (see, e.g., Baumol 1968; Baumol and Walton 1973) were writing about similar pricing issues in those areas and were nudging regulatory criteria and decisions away from the use of fully distributed cost and instead toward the use of incremental costs.

5. Conclusion

It is clear that the influence of economics on antitrust legal decisions and policy over the past two to three decades has been substantial. This influence has occurred through developments in economics thinking, through the elevation of economists' status and positions at the DOJ and the FTC, and through the wider participation of economists in antitrust litigation generally.

Reasonable economists can differ as to the wisdom of some of these developments and as to the particular stringency of enforcement (or lack thereof) over the past few decades. But few can argue with the proposition that economists' influence has increased.⁶³

Nirvana has not yet arrived, however. There are at least four areas where further creative economics thinking and influence could encourage better antitrust decisions and policy. First, there is the ongoing dilemma of how to take into account the efficiencies that may accompany a proposed merger. The tradeoffs of the potential welfare losses from heightened market power as against the potential improved efficiencies have been apparent at least since Williamson (1968). But improved efficiencies are easy to promise and may be difficult to deliver;⁶⁴ and “unscrambling the eggs” of a merger a few years after it has been approved and the efficiencies have failed to appear may be difficult or impossible (in addition to the difficulties of even trying to measure whether efficiencies have indeed appeared or not).

Second, unilateral predatory behavior needs a more nuanced approach. Current antitrust decisions – as enunciated in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1992), and recently re-affirmed in *Weyerhaeuser Co. v. Ross-Simmons Lumber Co.*, 127 S. Ct. 1069 (2007) – portray predation as a low-price strategy that is strictly a narrow investment involving an initial investment in below-marginal-cost pricing that will be recouped in higher prices and profits after the target firm departs from the market. Lost in this narrow approach are the larger issues of whether achieving a reputation for below-cost pricing might deter future entry or deter fringe firms that might otherwise be inclined to be mavericks. Achieving this reputation

could make the action worthwhile, even if the specific instance under scrutiny would (when the analysis is narrowly confined to only the costs and returns in this instance) not appear to be profitable.⁶⁵ Further, applying even this narrow cost-benefit paradigm to non-price behavior has proved difficult.⁶⁶ And the issue of bundled discounts, as portrayed in *LePage's Inc. v. 3M*, 324 F.3d 141 (2003), has roiled antitrust thinking.⁶⁷

Clear economics thinking can surely help. For example, the concept of “no economic sense” – that a price or non-price action should be condemned if it made no economic sense for the firm undertaking it unless the target firm disappeared from the market or would otherwise be disciplined – is surely one direction that is worth pursuing (although it does not encompass the strategic reputation issues raised above).⁶⁸ There may well be other directions that good economics thinking can uncover.

Third, the issue of market definition in Sherman Act Section 2 monopolization cases remains in an unsatisfactory state. This problem is at the center of the so-called “cellophane fallacy”: The Supreme Court in *U.S. v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377 (1956), decided that the relevant market for analyzing du Pont’s market share was “flexible wrapping materials”, in which du Pont’s cellophane had less than a 20% share, rather than cellophane itself, which du Pont dominated.

The Court reached this decision by noticing that du Pont was constrained from raising its cellophane prices by the likelihood that it would lose too many customers to sellers of other flexible wrapping materials. The difficulty with this approach (as was pointed out by Stocking and Mueller (1955)) is that a monopolist of cellophane would be expected to maintain a price that would have exactly this property. Accordingly, this “test” cannot distinguish between a monopolist of cellophane and a competitor in the flexible wrapping materials market.⁶⁹ Nevertheless, this test frequently appears in the market definition parts of monopolization decisions.⁷⁰

The economics textbook notion of what distinguishes a monopoly often stresses the excess profits that are being earned by the monopoly (and this was a large part of Stocking and Mueller’s (1955) claim that du Pont did have market power⁷¹); but, as was discussed above, since the mid 1980s accounting profits have largely disappeared from economists’ efforts to test the S-C-P paradigm, and the same concerns

would plague most profits-based efforts at market definition for these Section 2 cases. Clearly, more creative thinking is warranted.⁷²

Fourth, economists need to lead the effort to make a retrospective assessment of the efficacy of antitrust enforcement, especially merger enforcement. Are the DOJ and FTC drawing the right “lines” in their decisions as to whether to challenge or approve mergers?

The answer to this question cannot be learned from examining the number of challenges to mergers per year, or examining the characteristics of the mergers that are challenged or of the mergers that are successfully challenged (since one can never know the “counterfactual” with respect to those mergers). But post-merger pricing studies of those mergers that are allowed to proceed – especially those mergers that are “close calls” (as indicated by whether the agencies made a “second request” to ask for additional information from the merger proponents) – should yield useful information. If these studies indicate that post-merger prices have not increased (*cet. par.*), then merger policy may have been too strict; if the studies instead indicate that post-merger prices have increased significantly, then merger policy has been too lenient.⁷³

In sum, antitrust economics still has important tasks before it. I hope that there will be supply that will respond to this demand.

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NOTES

1. This is frequently described as the exercise of “prosecutorial discretion.”

2. Historically a second strain of antitrust was present: American populism, with its fears of bigness and its goal of keeping economic institutions small and locally oriented. That strain has disappeared from current enforcement and interpretation.

3. Arguably, there is a fourth thrust as well: restrictions on price discrimination, under the Robinson-Patman Act, which was a 1936 strengthening of Section 2 of the Clayton Act. However, the DOJ has not brought a Robinson-Patman lawsuit since the early 1960s, and the FTC's suits have declined almost (but not quite) to zero (Kovacic 2003); private plaintiffs rarely win the few cases that they bring. The Antitrust Modernization Commission (2007), which was tasked by Congress with recommending modifications in the antitrust laws, recommended outright repeal of the Robinson-Patman Act.

4. Although most antitrust enforcement efforts are phrased in terms of preventing anti-competitive acts by sellers, antitrust enforcement applies (in principle) equally to anti-competitive acts by buyers (and thus to the exercise of monopsony power as well as monopoly power).

5. Such suits may be settled by agreements by the merging parties to divest sufficient assets so as to maintain a sufficiently competitive environment.

6. See, for example, Hahn et al. (2006) and White (2006b).

7. This section draws on parts of White (1999).

8. I have been unable to determine when the phrase "industrial organization" was first used to describe the specific field of microeconomics that has now come to be associated with that phrase or when the phrase came into common use for describing the field. I have found a 1937 journal article title that comes close: "The Organization of Industry and the Theory of Prices" (Burns 1937). Marshall (1920, Book IV, chs. VIII–XII) does have five chapters that have the words "industrial organization" in their titles; but these chapters focus on issues of the firm (such as economies and diseconomies of scale) rather than on issues of industry and markets. Schumpeter (1954, pp. 948–950), in discussing the "contributions of the applied fields" to the development of economics thought "from 1870 to 1914 (and later)" briefly discusses the category of "railroads, public utilities, 'trusts,' and cartels"; but all of his discussion is focused on railroad and public utility economics. See more generally the discussion in De Jong and Shepherd (2007).

9. In 1942 when a collection of articles was published by the AEA (1942), titled *Readings in the Social Control of Industry* and reprinting a collection of 15 articles on IO-oriented topics that were published between 1934 and 1940, none of the articles had "industrial organization" in its title, although the Burns (1937) article was among them; but the "Preface" to the volume (Homan 1942, pp. v–vi) mentioned that the selection of the articles followed "the principle of confining attention to the more general problems of public policy toward industrial organization and control..." See also Peltzman (2007).

10. See Shepherd (2007); and see De Jong and Shepherd (2007) more generally for mini-biographies of some of the leading figures in IO during the 1930s and after.

11. The TNEC was created by an act of Congress in June 1938 and ended in April 1941. In its three years of existence it generated 37 volumes of testimony, two volumes of recommendations, and 43 monographs. Its data collection efforts provided the precedent for the *Census of Manufactures*, which first published data for 1947. For an example of its monographs, see Wilcox (1940).

12. See Grether (1970) for a listing.

13. By the late 1950s and early 1960s the S-C-P paradigm was also being applied to regulated industries; see, for example, Meyer et al. (1959) and Caves (1962).

14. Also, in *U.S. v. E.I. de Nemours and Co. et al.*, 353 U.S. 586 (1957) the Supreme Court ruled that du Pont had to divest its 23% stock ownership in General Motors; but again, this was a vertical separation.

15. The major cases in this series included: *U.S. v. Bethlehem Steel Corp. et al.*, 168 F. Supp. 576 (1958); *Brown Shoe Co. v. U.S.*, 370 U.S. 294 (1962); *U.S. v. Philadelphia National Bank et al.*, 374 U.S. 321 (1963); *U.S. v. Aluminum Company of America et al.*, 377 U.S. 271 (1964); *U.S. v. Continental Can Co. et al.*, 378 U.S. 441 (1964); *FTC v. Consolidated Foods Corp.*, 380 U.S. 592 (1965); *U.S. v. Von's Grocery Co. et al.*, 384 U.S. 270 (1966); *U.S. v. Pabst Brewing Co.*, 384 U.S. 546 (1966); *FTC v. Proctor & Gamble Co. et al.*, 386 U.S. 568 (1968); *Citizen Publishing Co. v. U.S.*, 394 U.S. 131 (1969); and *U.S. v. Falstaff Brewing Corp.*, 410 U.S. 526 (1973). It was in *Von's* that Justice Potter Stewart, in dissent, made a remark that seemed to typify the government's success in challenging mergers: "The sole consistency that I can find is that in litigation under Section 7, the government always wins", 384 U.S. 270, 301 (1966).

16. Also, see the later surveys of entry that are to be found in Siegfried and Evans (1992, 1994) and Geroski (1995).

17. See Weiss (1971, 1974), Bresnahan (1989), Schmalensee (1989), and Caves (2007) for summaries.

18. See Demsetz (1973, 1974).

19. The *RJE* was originally (1970) the *Bell Journal of Economics and Management Science*, then (1975) the *Bell Journal of Economics*, and then (1984) the *RJE*.

20. The *RIO* was originally the *Industrial Organization Review*. It became the *RIO* in 1984.

21. That the appearance of this volume marks a milestone in the relationship of IO to antitrust is highlighted by the fact that there was not even a chapter devoted to antitrust economics in the original two-volume *Handbook of Industrial Organization* (Schmalensee and Willig 1989a, 1989b). There was a section in the second volume that was devoted to "Government in the Marketplace". But all five chapters in that section (Noll 1989; Braeutigam 1989; Baron 1989; Joskow and Rose 1989; and Gruen-specht and Lave 1989) were focused on regulation, not antitrust.

22. As Letwin (1965, pp. 71–77) and Scherer (1970, p. 424) have noted, economists in the 1880s were generally unconcerned about the rise of the “trusts” and thus were not advocates of passage of the Sherman Act.

23. See also Blaisdell (1922), Henderson (1924), Stevens (1940), and Mueller (2004).

24. The DOJ acquired antitrust enforcement authority under the Sherman Act in 1890. Until 1903 enforcement was carried out directly within the Office of the Attorney General, and from 1903-1933 it was carried out within the Office of the Assistant to the Attorney General (White 1984). According to Edwards (1940), who cited Thurman Arnold, “the great trust-busting campaign of Theodore Roosevelt [which included the filing and litigation of the Standard Oil, American Tobacco, and other important antitrust cases] was conducted with 7 lawyers and 4 stenographers.”

25. For a discussion of this era, see Williamson (2003).

26. For a different view, see Mueller (2004).

27. Kwoka and White (1989, 1994, 1999, 2004a, 2009) have written about the “revolution” of the application of economics reasoning to antitrust in the 1970s and afterward and enlisted economists who participated in major antitrust cases to write analyses of the cases in which they were involved. Some of the 1970s cases are discussed below.

28. See also Eisner (1991).

29. Also in the late 1970s and the 1980s the number of economics consulting firms that had extensive antitrust litigation support practices increased substantially. Often these firms were led and staffed by “alumni” from the economics staffs of the two enforcement agencies.

30. The cases about which they were writing were, respectively, *U.S. v. New York Great Atlantic & Pacific Tea Co. et al.*, 173 F.2d 79 (1949); *American Tobacco Co. et al. v. U.S.*, 147 F. 2d 93 (1944), 328 U.S. 781 (1949); and *FTC v. Cement Institute et al.*, 333 U.S. 683 (1948). See also Adelman (1949b).

31. *U.S. v. United Shoe Machinery Corp.*, 110 F. Supp. 295 (1953), 347 U.S. 521 (1954).

32. The DOJ’s major suits against IBM (initiated in 1969) and AT&T (initiated in 1974) eventually involved large numbers of economists on both sides, and this widespread exposure of economists to antitrust may well have been influential in encouraging further participation in other cases and in encouraging economists’ writing about antitrust cases.

33. In addition to the major achievements mentioned in the text, honorable mention might include: (a) Antitrust economists were among the early advocates of the economic deregulation of securities and banking markets, transportation markets, telecommunications markets, and energy markets; see, for example, Eads (1975), Mann (1975), and Weiss (1975); (b) Antitrust economists have been major advocates for larger fines and the continuation of treble damages in private antitrust suits as instruments for deterrence; see for example Salop and White (1986, 1988); and (c) Antitrust

economists have been major advocates of the repeal of the Robinson-Patman Act; see, for example, Adelman (1949a, 1949b, 1959).

34. Accessed at: <http://www.usdoj.gov/atr/public/guidelines/hmg.htm>

35. An earlier set of DOJ Guidelines were published in 1968 but proved unsatisfactory and were largely scrapped when the 1982 Guidelines were adopted. The economists at the DOJ played an extensive role in the development of the 1982 Guidelines, especially the market definition paradigm that is discussed below; see White (2000).

36. The HHI was used as the measure of seller concentration in the Guidelines, rather than the four-firm concentration ratio (which was far more commonly used prior to 1982), partly because it is a more complete measure of the shares of all firms in the market and partly because Stigler (1964) showed that it could serve as an indicator of the ease with which sellers who were trying to coordinate their pricing could distinguish between random market share fluctuations and the market share changes that could occur as a consequence of a surreptitious price cut.

37. Actual enforcement, however, has indicated that substantially higher HHI levels are the de facto thresholds. See Leddy (1986), Coate (2005), and Coate and Ulrick (2005).

38. As Werden (2003) has indicated, the first suggestion for using this approach to define relevant markets for merger analysis was by Adelman (1959). Other efforts at defining markets, such as Elzinga and Hogarty (1973) and Horowitz (1981), proved less satisfactory than the approach outlined in the text.

39. See, for example, Katz and Shapiro (2003).

40. Unilateral effects could also occur if a dominant firm merged with one of its rivals, even in a homogeneous goods industry (Stigler 1965). The post-merger concentration (and merger-induced change in concentration) guideposts would probably be sufficient to catch such mergers; but, to be on the safe side, the Guidelines also indicate that any merger involving a firm that has a market share of 35% or higher will receive special scrutiny.

41. See, for example, Werden and Froeb (1994, 2007) and Pelcovits (2004).

42. An earlier treatment of this topic can be found in White (1989).

43. "...a flat rule against tying arrangements, regardless of whether they serve a useful purpose, appears justified" (Kaysen and Turner, 1959, p. 159).

44. At least part of the reason for many economists' harsh view of RPM was the experience of the 1930s, when small retailers (and especially pharmacists) lobbied for protection against "unfair" competition from large chain stores. One legislative reaction, already noted above, was the Robinson-Patman Act of 1936, which strengthened the Clayton Act's Section 2 prohibitions on price discrimination (because, the small retailers alleged, the chain stores were extracting discounts from manufacturers that were unavailable to smaller retailers). Another response, the Miller-Tydings Act of 1937, authorized the states to legalize RPM (which also went by the name

“fair trade”), so that the small retailers could convince manufacturers to impose RPM and thus force the chain stores to sell at the same prices as the smaller retailers.

45. It is worth noting that, though Stigler was subsequently associated with the “Chicago School”, at the time of the *Report* he was a Professor at Columbia University. See Peltzman (2007).

46. White (1989) offers some reasons for these harsh views.

47. It was also argued that tying and similar vertical restraints could be a way of making sure that the product functioned properly and thus preserving the goodwill of the manufacturer and of dealing with potential free riding problems.

48. See also Bowman (1955). Telser acknowledged that RPM could be a cover for a retailers’ cartel or even for a manufacturers’ cartel. What was important, however, was his demonstration that a manufacturer *unilaterally* might find RPM to be in its interests.

49. See, for example, Bork (1954, 1978); Bork and Bowman (1965); McGee 1971); Bowman (1973); and Posner (1976). For a discussion of some of the “counter-revolution” literature that showed that vertical restraints and vertical mergers might not be as benign as the Chicago revolution claimed, see White (1989). See also Perry (1989). For a recent summary of the empirical evidence on vertical integration, which finds primarily benign outcomes, see Lafontaine and Slade (2007).

50. However, in *U.S. v. Colgate & Co.*, 250 U.S. 300 (1919), the Court decided that it was legal for a manufacturer to decide what the retail price of an item should be and then unilaterally decline to deal with any retailer that failed to adhere to that price. The tension between *Dr. Miles Medical* and *Colgate* remained a problem until the *Leegin* decision in 2007, which is mentioned below.

51. *Albrecht* involved maximum RPM.

52. Prior to the 1914 passage of the Clayton Act’s Section 3 prohibition on tying, the Court had upheld tying in a patented product case: *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912).

53. Four years earlier, in *White Motor Co. v. U.S.*, 372 U.S. 253 (1963), the Court had declared that it did not know enough about territorial restrictions to be able to decide whether to condemn them or not.

54. There were exceptions to the pre-1970s pattern described above. For example, in *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961), the Court declined to condemn a requirements contract and declared that exclusive dealing should be judged by a rule of reason. That same year, in *U.S. v. Jerrold Electronics Corp.*, 365 U.S. 567 (1961), the Court affirmed a lower court opinion that allowed tying for a start-up situation. But these and a few other cases were exceptions. The general pattern was as described in the text.

55. For a discussion of one worthwhile challenge in the 1980s, see White (1985).

56. On *Microsoft*, see Rubinfeld (2009); on *Dentsply*, see Katz (2002, 2009).

57. See for example, McGee (1958) and Telser (1966); see also Task Force (1969) and Peltzman (2005). McGee also called into question the factual issue of whether Standard Oil of New Jersey had actually engaged in the predatory practices in the late 19th century that had formed the basis of the Supreme Court's decision finding it guilty of Section 2 violations (*U.S. v. Standard Oil Co. of N.J. et al.*, 221 U.S. 1 (1911)) and for the company's subsequent forced break-up into a number of constituent companies.

58. Recall that Turner had a Ph.D. in economics as well as a law degree and thus can legitimately be included in this list of economists' accomplishments.

59. The Areeda-Turner rule spawned a flurry of economist critiques and refinements. See, for example, Scherer (1976), Williamson (1977), Baumol (1979), Joskow and Klevorick (1979), and Brodley and Hay (1981).

60. For a discussion, see Elzinga (1999).

61. For a discussion, see Burnett (1999).

62. As will be argued below, however, the "strict investment-plus-recoupment" approach is not sufficiently nuanced, since it does not encompass strategic approaches, such as a company's being willing to absorb a loss through below-marginal-cost pricing in one market, without recoupment, so as to gain a reputation for being aggressive and thereby discouraging entry (or expansion by rivals) in other markets (and thus the recoupment is effectively achieved in those other markets).

63. There is an interesting question – which will be addressed only briefly here – as to why the legal profession – at the enforcement agencies, in private practice, and in the judiciary – were willing to accept the expanded influence of economics and economists on their legal terrain. A few potential (and potentially complementary) explanations can be offered: First, the ideas may well have been too good to be ignored. Second, some agency leaders (e.g., Donald Turner, Thomas Kauper, William Baxter, James Miller, Robert Pitofsky) had come from an academic background and may have been interested in the broader perspective that an academic background often encourages; the same might be said of some influential judges (e.g., Richard Posner, Frank Easterbrook, and Stephen Breyer). Also, some of these same individuals had advanced training in economics and/or had advanced economics instincts. Third, especially for lawyers in private practice, the addition of economists in cases meant a greater need for lawyers (and billable hours) to ride herd on these extra participants. Fourth, special programs to improve the economics literacy of the judiciary may have had some effects. Further exploration of these ideas will have to await another day.

64. For an example, see Kwoka and White (2004b). However, for a closer call on these tradeoff issues, see Baker (2009).

65. See, for example, Brodley et al. (2000).

66. See, for example, the discussion in Edlin and Farrell (2004).

67. The AMC *Report*, for example, devoted a surprisingly large amount of space to the decision and to remedies. For a discussion of *LePage's*, see, for example, Roberts (2009).

68. See, for example, Werden (2006) and Ordoover and Willig (1981, 1999).

69. Although the Court's "test" would appear to be similar to the Merger Guidelines' SSNIP test, the crucial difference is that the SSNIP test is intended to be forward looking, in order to answer the question, "Will this merger create or enhance market power," whereas the Court was applying it in the context of trying to determine whether du Pont already had market power. See White (2008).

70. See the discussion in White (2008); see also *U.S. v. Visa and MasterCard*, 163 F. Supp. 2d 322 (2001), 344 F.3d 229 (2003).

71. Stocking and Mueller (1955) also argued that du Pont's prices for cellophane did not move in response to changes in other flexible wrapping materials' prices.

72. Some suggestions are offered in White (2008).

73. Other observations and suggestions with regard to current merger enforcement can be found in White (2006a).

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NEW MARKETS AND NEW STRATEGIES IN ARGENTINA'S WINE REVOLUTION

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We have a coherent and combative position...transform an activity dedicated to making massive and undifferentiated products, to products high in quality able to be differentiated by the market. Centro de Bodegueros de Mendoza, "El valor de la coherencia," *Bodegas y terruños*, # 1 (March 1999), 44.

The rise of exports starting in the second half of the 1990s was perhaps the most transcendental phenomenon of the local wine industry, not only because it reflected the enormous potential of a greater insertion of domestic production internationally, but also because of its repercussions for wine production as well as for the marketing of Argentine wine and consequently for wine business strategies. Daniel Aspiazu and Eduardo Basualdo, *Estudios sectoriales. Componente: Industria vitivinícola*. Buenos Aires: CEPAL-ONU, 2003, 15.

Argentina emerges. Argentina's wine industry is experiencing astonishing growth, both in production and international acceptance... And if you taste a rich Argentinean Malbec, all this makes perfect sense. Adam Strum, "Top 10 Wine Stories of 2006," *The Wine Enthusiast*, XX:1 (January 31, 2006), 10.

I know that 50 percent of spending on marketing is wasted.
The problem is, I don't know which 50 percent.
Old marketing dictum

ABSTRACT. Early in the twentieth century, Argentina became the world's fifth largest wine producer, but until very recently its wines were little known and even less appreciated outside of the country. During the last decade, however, Argentina's wine isolation came to an end with exports growing in excess of 30 percent per annum. In recent years, international demand, particularly for the country's emblematic Malbec, has expanded so rapidly that winery owners complain they are reaching the limit of capacity and fear that they will soon be unable to meet growing demand from external markets. This article analyzes the reasons for the international emergence of Argentine wines in the new millennium. Major themes include: an analysis of the drivers of wine export development; the identification of major comparative advantages that have contributed to export growth; an evaluation of the elements of the industry's successful export business and marketing strategy; and a discussion of prospects for future industry growth and of the specific role of Malbec in that process.

JEL: A11, L17, L66

1. Introduction

Early in the twentieth century, Argentina became the world's fifth largest wine producer, but until very recently its wines were little known and even less appreciated outside of the country. During the last decade, however, Argentina's wine isolation came to an end. In the words of the world's most influential wine critic, Robert Parker, "a new generation of Argentinean vignerons [has] begun to realize this country's, and particularly the province of Mendoza's, extraordinary potential. ... Now their finest wines can compete on the world stage ... one after another breakthrough wines have pushed Argentina to the forefront of the modern winemaking revolution."¹

The sharp rise in the export of Argentine wines demonstrates that Parker's enthusiasm is shared by international consumers. In only eight years between 1998 and 2006, they grew at a rate of over 30 percent a year. The leading protagonist of Argentina's appearance on the international stage has been its numerous, highly appreciated bottlings of Malbec. Of wines sent abroad, the varietal more than doubles its closest competitor (Cabernet Sauvignon), totaling 30 percent of exports overall and 50 percent of fine wine sales. As Parker explains it, "Malbec, a grape long considered challenging and often disappointing in France, produces prodigious wines of great perfume, quality and longevity in Argentina. Malbec is the red wine hope of Argentina..."² Led by the growing popularity of its emblematic Malbec grape, Argentina has rapidly built a reputation as a producer of desirable, sought after wines.

In 2007 Argentine wines were exported to 116 countries, with a particularly strong showing in the United States. Between 2005 and 2006 alone, sales to the U.S. increased a full 78 percent in value. Presently, the U.S. market receives nearly 40 percent of all Argentine wines exported.³ Great Britain and Canada, with 8 percent each, have been the next largest export destinations, followed by Brazil, Denmark, the Low Countries, Russia, and Sweden.⁴ International demand has been so high that in 2007 winery owners began to complain they were reaching the limit of capacity and were increasingly having trouble meeting demand from external markets.⁵

In large part the success of Argentina's export development has resulted from the convergence of possessing an attractive grape variety and producing appealing wines with it. But that is far from the whole story. This paper analyzes the reasons for the international

emergence of Argentine wines, and specifically of the country's emblematic Malbec. To understand the industry's success, I examine various questions:

1. When did Argentina, historically a country that exported only an infinitesimal percentage of its total wine production, begin to make an effort to reach international markets? Judging by their success, the Argentines made the right decisions, but, why, and who made them?
2. Does Argentina possess unique comparative advantages that have contributed to wine export growth?
3. How have the Argentines achieved export growth and specifically built Malbec as an emblematic grape? In other words, what have been the successful elements of the industry's export business and marketing strategy?
4. Is Malbec a temporary trend? Will it last medium and long-term?

Before addressing these questions, it is important to note that Argentine wines have increased their international presence at a time of notable growth in non-traditional consumer markets, especially of New World wines and of higher quality fine wines. As wine consumption has been decreasing in Europe's historic wine countries, France in particular, expansion in the U.S. and the U.K. has been significant; with a growth rate of approximately 5 percent per year, the United States is predicted to surpass France and Italy by the end of the decade to become the leader in global wine consumption.⁶

All these expanding markets share important characteristics that illuminate Argentina's success. Their consumers characteristically seek diversity and are therefore open to new types of wine. Many are confused by traditional wine classifications such as Bordeaux or Chianti. These names seem less useful for predicting the taste or quality of a wine than the identification of specific grape varieties, a trend that achieved prominence with the success of the California industry in the 1980s. Argentina's emphasis on Malbec fits well the desire for "something new," and is at the same time clearly identifiable.

It is commonplace to believe that Argentina simply adopted the successful export strategy launched by neighboring Chile nearly twenty years earlier when, in fact, Argentine winemakers point to Australia as their model. The attractiveness of Australia is not surprising given the parallel between Argentina's focus on Malbec and the central importance of Shiraz to that country's enormous

success in recent years.⁷ Argentina may not have copied Chile's strategy, but the success of Malbec in the creation of Argentina's international identity has not been lost to its trans-Andean neighbor. Chile has tried to market Carmenere as its own unique contribution to wine consumers just as South Africa has attempted to establish an identity with Pinotage. Yet neither has paralleled the success of Argentina's Malbec. Notably, in the period that Argentine exports to the US were growing by nearly 80 percent, Chile, barely achieved any increase at all.⁸

2. Before Exports

Argentina's recent international success obscures the fact that an export strategy was almost totally absent from country's wine industry for the first hundred years. From its beginnings in the 1880s, the core strategy was to produce for an expanding *domestic consumer market* based on the perception of a rapidly growing local demand for cheap wines that would perennially outstrip production capacity. Analysts from the turn of the twentieth century through the 1970s largely concurred about the strong belief in a "comfortable" market. That market was composed largely of immigrants from Italy and Spain, and later by their descendents. For these consumers, wine was considered a necessary part of the daily diet. Although coming from places with well-established wine traditions, they rarely showed interest in a high quality product. Rather, the main concern was access to abundant and, above all, cheap wines.

In the 1970s, when Argentine consumption reached an all-time high of ninety liters per-capita, the public drank wines made for the so-called "Argentine taste." Heavily colored and alcoholic – bordering on thirteen percent –, they ended up as a sweetish drink similar to poor quality sherry. They were, in the words of prestigious winemaker Paul Hobbs, "tired wines." As a result, it was commonplace for consumers to make attempts at "improving" wine flavor by adding ice and soda to both whites and reds.⁹

Just when wine production was reaching its all-time high in the late 1970s, the cornerstone of the domestic market was starting to show clear fault-lines as Argentines began to drastically curtail their consumption. At the end of the decade, a severe economic recession cut deeply into the purchasing power of the population, and simultaneously, alternative beverages, specifically beer and soft drinks

began to experience rapid growth. Necessity would have to become the mother of invention for the survival of the Argentine wine industry.

3. Argentina's Wine Revolution

Faced by an enormous imbalance between supply and demand, a small number of forward-looking entrepreneurs realized that the very viability of the industry was threatened without profound and fundamental changes; the key change was to seek new prospects beyond the shrinking domestic market. Led by Nicolás Catena Zapata, one of the few winery owners who survived the crisis with all his resources intact, they began in the late 1980s a process that would become known as the “*reconversión*” of the Argentine wine industry. Among the key strategies that drove the *reconversión* were:

- The pursuit of international consumers, given the contraction of the industry's local market.
- Concentration on the production of wines that could attain sufficient quality to compete internationally.
- Sweeping upgrades in technology both in the winery and in the vineyard focused on quality improvement.
- And guiding the whole process, a fundamental change from a producer-centered to a consumer-centered industry model.

4. Our Saviors May Not Speak Spanish

On a consulting trip to Argentina in 2000, French wine marketing guru Michel Bourqui declared: “Before you worked for a wine drinking market. Today you have to take aim at a market that looks for pleasure.”¹⁰ Translation: drinking market = domestic consumers; pleasure = international consumers. Bourqui's comments reflected an already prevalent faith among Argentine producers in the strategic importance of exports. By the time of his visit, more and more industry leaders had been insisting that international markets were the salvation of the industry. The bold assertion in the two-page title of a 1999 article in the industry association magazine is a case in point: “*Adapt the product TO THE TASTE OF THE INTERNATIONAL CONSUMER.*”¹¹ What had become an industry cant was repeated once more in 2004 by Angel Vespa, the Director of the

Wine Industry Association: “The Argentine wine sector faces a great mission: to consolidate its position as a trusted supplier of wines to broad international markets.”¹²

Judging by the numbers, the industry met Vespa’s challenge head on. Between 1998 and 2006, exports grew in quantity and dollar value by nearly equal percentages: 368 percent in volume and 366 percent in value. Even more notable, during the most successful years of the export boom from 2002 through 2006 earnings (404 percent) substantially outpaced gains in volume (338 percent), reflecting the emphasis on higher priced fine wines over cheaper table wines. In 1989, when wineries were just beginning to test the international waters, fine and reserve wines accounted for only 19 percent of exports, but by 1994 that proportion climbed rapidly to 53 percent. In 2006, a full 77 percent of exports were fine wines, and in 2007 the trend continued, reaching 82 percent by mid-year. Within the fine wine category, industry experts remark that sales of high-end products are growing nearly two times faster than their less expensive wines; indeed, the lowest priced wines have actually decreased in sales by over 10 percent. Quantitatively and qualitatively, it would appear that the title of a 1999 article in the wine association’s publication, early on in the process, did not exaggerate when declaring that: “*LA EXPORTACION DE VINOS TRANSFORMO EL SECTOR*” (*THE EXPORT OF WINES TRANSFORMED THE SECTOR*).¹³

In seeking the origins of this approach, the decisions of a handful of export pioneers stand out. At the top of the list is Nicolás Catena, owner of Bodegas Esmeralda and later Bodega Nicolás Catena Zapata in Argentina’s most important wine region of Mendoza. Coming from a family with a long tradition of successful production of table wines for Argentina’s undifferentiated domestic market, he took over the firm in 1963 at the age of twenty-two and made it into the country’s leading supplier of bottled wine. In the early 1980s, while pursuing a post-doc at the University of California Berkeley, he observed first-hand the rise of the Napa wine phenomenon, literally sitting at the feet of Robert Mondavi. Catena appears to have listened closely to Mondavi’s lessons about the enormous potential for New World wines to challenge the Old World in quality. And fully aware of the demand crisis in Argentina’s domestic market, Catena went about converting his own enterprise into a producer of internationally competitive wines. As he remarked:

Table wine ... didn't interest me any more. ... Obviously the fall in consumption that was happening surely had an influence, but I had already become enamored of the concept of quality. So I totally revised my objectives, and I began to invest in everything having to do with quality, in fine wines, nothing else. I didn't invest any more in table wines. ... I didn't abandon them but basically concentrated all my enthusiasm, my investment capacity, my best people, to producing a different quality of wine.¹⁴

What is particularly noteworthy about Catena's example is that he not only converted his winery to the production of premium wines but also decided from the outset to charge premium prices.

At the end of the '80s I began my research into the fine wine market in the United States. Immediately I discovered that whatever Argentine wines that were available were situated ... in the \$4 to \$6 price segment in wine stores. They were placed at price levels similar to Chilean wines, but were of inferior quality. ... I decided to adopt a different strategy. ... At the end of 1991, I began selling Catena Cabernet Sauvignon at \$15 to \$16 bottle retail and Catena Chardonnay at \$13 to \$14. We were successful. We quickly sold the whole harvest and also the next two harvests at the same price. ... Our project was and is to compete not only with the best wines of the New World but also with the best of the Old World.¹⁵

So, when Catena began exporting in 1991, he did not follow the model of other New World producers and try to compete initially with a low priced product and slowly raise the price along with the quality. Instead, Catena's first export wines at \$13 to \$16 were selling at two segments above his quite successful neighbor Chile, whose wines were directed almost entirely at the \$3 to \$7 range.¹⁶

Another of the country's largest wineries, Peñaflor, was also among a small group of Argentine producers that early on saw the importance of gaining distinctiveness through both quality *and* price. Even before Catena initiated his export project, Peñaflor began producing a high-end wine for the domestic market through its Trapiche winery. Angel Mendoza, the chief winemaker during much

of the 1980s and 1990s, explained the firm's first moves in this direction:

Peñaflor was already aware that things were changing, and we began to bet very seriously on fine wine as we saw that the moment of fine wine was approaching, more than anything else premium wine. They were already calculating an amount that they called aggregate value which produced a greater profit, that contributed more than what table wine did, and they were tired of competing in the table wine sector. ... As a result, the generation of Trapiche Medalla is born in 1983, which was a big bet on premium wine, seeking to make the most expensive wine.¹⁷

In 2000, when exports were beginning to take off, Peñaflor's strategy to simultaneously raise quality and price was explicitly tied to international expansion. As explained by export manager Juan José Canay: "You have to compete in the world. Nobody is desperate to have our wines, and if Argentina doesn't export, somebody else will. ... Argentina should not enter the world market with low prices because it is not a well thought out strategy. Chile entered the market with this strategy and now it can't get out." Peñaflor continued to move in this direction, increasing the average price of their export wines 35 percent between 2001 and 2007. During these years, the firm's export earnings rose 400 percent to the point that they totaled for some ten percent of all Argentine international sales. This helped make Peñaflor the ninth largest wine business in the world.¹⁸

5. What Doesn't Kill You Makes You Strong

What factors explain Argentina's remarkable transformation from a mass producer of relatively poor quality table wines for an undifferentiated domestic market to major international competitor in fine wines? First, the country's long tradition of wine production provided a foundation on which to build. Second, Argentina possesses a large domestic market that, although weakened, has been substantial enough to provide a reliable cushion for industry change. Third, conditioned by a perennial "culture of crisis," Argentines have learned to maneuver in order to lose the least or to make the most of an uncertain environment. This has led to the emergence of a parallel

“culture of agility” clearly evident in the decision-making of major protagonists of the reconverted industry. Fourth, when making their wines, the industry enjoys considerable flexibility in everything from rules and regulations to the use of appropriate *terroirs*. And finally, the decision to “reconvert” came at a moment as rare as it was lucky in Argentine history: economic stability coincided with the availability of substantial financial resources to accomplish the task.

In the 1990s, when the prospects of export growth gained precedence, Argentina was hardly starting from scratch. The country had a century-old wine industry with numerous established vineyards, a legion of wineries of all sizes and shapes and an enormous amount of accumulated experience from laborers in the vineyards to high level managers in the wineries. In all these areas, of course, it was crucial to upgrade in order to achieve internationally competitive wines.

The vineyard situation is an interesting case in point. In the 1960s and 1970s huge government tax breaks had encouraged volume wine production as never before. As a result, French vines that had been planted decades, in some cases up to a century earlier, were ripped out and replaced with *uva criolla* stock. The original grape brought by Spanish missionaries in the colonial period, the *uva criolla*'s ability to produce massive amounts of fruit was matched by the abysmal quality of its wines. Malbec vineyards, with the grape that would become the emblem of the *reconversión*, were nearly wiped out, declining from 50,000 hectares in 1970 to only 10,000 in 1990. Still, Malbec fared better than other fine varieties. Cabernet Sauvignon had been reduced to 3,500 hectares, and there were barely 1,000 left of Merlot and 80 of Chardonnay. Then, during the worst years of industry decline in the 1980s many vineyards were completely eradicated to make way for suburban development. Nevertheless, substantial acreage of excellent vineyard land remained as well as a critical mass of good vine stock necessary to begin the process of transformation.¹⁹

The fate of wineries paralleled that of the vineyards. Small and middle-sized establishments were particularly vulnerable during the years of industry crisis. Those that simply could not afford to update and upgrade for the most part closed their doors. It was the larger, better capitalized firms that survived. Survival did not mean, however, that the transition to export production would be rapid or easy. Famed California winemaker Paul Hobbs, who became a prominent actor in the transformation of Catena from massive producer of bulk wines to quality

leader, vividly addresses the technological gap as he recounts his first visit to the Esmeralda winery in 1988.

It was so ancient, their technology, all the equipment. Everything had been set in place back in the early 1900s. It hadn't been improved upon since then. ... It was very archaic. It was so primitive that I didn't know how to use the equipment they had, and I was doubtful of the results that it would have in most situations.²⁰

A similar situation affected the human resources in the industry. Wineries had employed enologists from the dawn of the industry. But as Carlos Catania, the head of the Enology Department at the government's Centro de Estudios Enológicos in Mendoza observed, these individuals saw themselves as wine factory foremen whose job was simply to "ferment the wine and put it in giant tanks. Since before people thought it was the same difference, whatever grape you used, the process couldn't have been any more industrial."²¹ Similarly, Paul Hobbs's unflattering comments on the content of winemaking knowledge in Argentina parallel his negative description of the physical equipment: "I spent one afternoon in the winery, and tasting their wines, I was shocked. They were destroying the grapes. I couldn't imagine what they were doing. ... They didn't understand malolactic fermentation; they didn't understand anything to do with barrels. It was all winemaking from the beginning."²²

Lack of varietal quality in the vineyards, outdated wineries and deficient enological knowhow: certainly. But the vineyards, the wineries and experienced personnel were still present in Argentina, even after the worst downturn in the industry's history. To achieve levels of quality capable of appealing to international consumers, however, required major investment in all three areas. And that is when luck played a crucial role. Just at the time that eventual export leaders were beginning to make the decision to upgrade, macro-economic circumstances in Argentina favored an enormous influx of private investment. Beginning in the 1990s as part of its deregulation of the Argentine economy, the government of Carlos Menem (1989-1999) eliminated rules limiting foreign investment, liberalized the currency exchange market, ended export duties and eased restrictions on imports, specifically of capital goods and services that were essential to the industry's upgrading ventures. Also, low inflation and a mandated dollar-peso parity exchange rate helped create a

stable environment – with fixed domestic costs – attractive to potential investors. Under these conditions, foreign banks in particular were eager to lend and became quite aggressive at making low interest, long-term loans to wine entrepreneurs. The overvalued Argentine currency made the prices of imports of key equipment exceedingly attractive. Surprisingly, the strong peso did not prevent land and labor costs in the country from remaining cheap. Excellent vineyard land in Mendoza sold for half of what it would cost in Chile, a third of the price of Australia and a tenth of the value of Napa or France. In the end, the investment in the Argentine industry during the heart of the *reconversión* was truly staggering. Between 1991 and 2001 it totaled an estimated \$1 billion from abroad and \$500 million locally; an additional \$200 million is predicted through 2010. The importance of the building exports as an incentive is clear considering that 70 percent of investments have gone to fund production for the international market.²³

Concretely, the industry used the strong peso to buy top quality imported vine stock, cutting-edge winery equipment and the world's most prestigious traveling consultants. In addition to importing Quality A clones, largely from France and Italy, investments in local nurseries has provided an accessible supply of vines adapted to local conditions. Vineyards also benefited, progressively changing over from flood to drip irrigation. For the wineries, technological innovations meant importing a broad variety of equipment that had previously been absent in the Argentine industry including small oak barrels, stainless steel fermentation and storage tanks, bladder presses, destemmers and bottling equipment. One of the most significant technological innovations was the incorporation of modern cooling systems; Catena, for example, was the first to construct a large cold chamber for the low-temperature fermentation of white wines. By the end of the 1990s, some forty to fifty Argentine wineries had upgraded nearly all their equipment bringing their technology up to a level that matched their most advanced peers anywhere on the globe. As international wine consultant Sophie Jump pronounced, "Most of them have got facilities that the French would die for."²⁴

With its new equipment, the industry had taken vital steps on the road to internationally competitive wines. But a major obstacle remained: the lack of enological know-how. This was overcome through genuine improvements in the enological training received locally and from the assimilation of decisive influences from the

outside. Within Argentina, the industry's increasing demand for trained experts produced the exponential growth of regional university programs and graduates. But the most visible development came from the outside. New investments in the industry underwrote travel abroad for local wine makers for learning trips to prominent wineries as well as for formal study programs. And it paid for prestigious wine professionals to come to Argentina to guide innovation. Nicolás Catena had begun the trend in 1988 when he hired Californian Paul Hobbs, who had worked with Robert Mondavi on his Opus One project, to play a central role in the transformation of Catena Zapata. In subsequent years, the contracting of foreign consultants really picked up speed. Famous French winemaker Michel Rolland arrived at Peñaflores's Trapiche winery in 1996, to be followed by other major figures including Alberto Antonini (Nieto Senetiner and Altos de Medrano), Jacques Lurton and Olivier Ruhard (Bodega Lurton), Arnaud Meillan (Favre Montmayou) and Robert Pepi (Valentín Bianchi). Particularly in more recent years, consulting has not been limited to the production area, extending to marketing and branding. For example, experts from the University of South Australia's Wine Marketing Group Larry Lockshin and Tony Spawnton have put on well-attended seminars in Mendoza with titles such as "Branding Your Wine for Success."²⁵

Ironically, a key element of the explosive growth in Argentina's wine exports, particularly in the new millennium, has been the continued presence of a large, if diminished, number of local consumers. Back in the 1970s, the country's primary market of Buenos Aires had boasted a per-capita consumption of 114 liters, placing its wine drinkers' capacity at a level roughly equal their peers in the world's highest wine consuming cities, Paris and Rome. True, these levels of consumption have long been a faint memory. And as mentioned previously, their precipitous fall was clearly a driving force behind the resolve to export.²⁶

Yet even with this decrease, Argentina is still the world's fifth largest wine consuming country. Indeed, the new emphasis on exports tends to cloud an important reality: in the midst of the export boom, domestic consumption has remained consequential. In 2005, for example, the national market still drank 82 percent of all wines produced in Mendoza. And subsequently, per-capita consumption has risen from 29 liters to 34 liters. The highly successful Peñaflores firm exemplifies the continued importance of domestic consumption.

Just as there is no denying its export success, equally compelling is the strength of Peñaflor's sales within Argentina, paralleling quite closely the industry trend by generating 88 percent of the firm's income. Additionally, as recently as 2007, of the approximately 2,000 wineries in Argentina, no more than 400 are involved internationally, and of that number a mere 20 concentrate 60 percent of exports. In short, the domestic market has continued to occupy an important place in the calculations of the country's wine industry.²⁷

This awareness of the sustained weight of the domestic market is shared by all major Argentine producers. The presence of this still large and even growing wine drinking public within Argentina facilitates making tough decisions in terms of investment and restructuring for export growth. Paradoxically, it is the substantial number of domestic consumers that permits producers to take relatively large risks in the export area because they have a strong backup within their own country.²⁸

A distinct shift in the taste preferences of Argentine wine drinkers over the past decade has actually strengthened export initiatives. As lower income groups shifted away from wine towards beer and soft drinks, wealthier and middle class consumers, many of whom spent their country's strong national currency in the 1990s on international travel, began to insist on wines that tasted "as good as" those they found abroad. An overvalued peso also boosted, for the first time in nearly 100 years, the importation of European and California wines some of which became taste setters. So, just as overall consumption was dropping in Argentina, the demand for premium wines was increasing. José Alberto Zuccardi, owner of Bodega Familia Zuccardi, one of the country's most successful export wineries, explains the important complementarities between wines produced for international and national markets. "We started to export in 1991. At that moment we were aware that the greatest growth would happen abroad, but that didn't mean that we weren't going to take care of the internal market. On the contrary, we learned many things abroad that we applied here, as much about taste as about design and packaging."²⁹

As winery and vineyard managers have been influenced in their production decisions by similar components of both international and Argentine "wine cultures," another set of experiential norms helps explain the success of the industry to re-invent itself in order to respond to new markets at home and abroad. They make up Argen-

tina's "culture of crisis." During much of its history since the early decades of nationhood in the 19th century, Argentina has been a country of crisis, or perhaps more accurately, multiple crises. In the second half of the 20th century both political and economic upheavals became particularly acute. Politically, these involved sudden, at times violent changes in government, characterized most palpably by armed coups and frequently repressive military regimes. Economically, especially striking have been succeeding stretches of hyperinflation reaching annual levels of up to 5,000 percent, wildly fluctuating exchange rates with radical devaluations and at least one period of rigid overvaluation.

Out of these very difficult, often tragic, times a cultural baggage has emerged with one important positive: an ability to react to rapidly to difficult situations by, when "necessary," radically changing directions. Luigi Bosca owner Alberto Arizu attests to the permanence of insecurity and to its impact. "We were accustomed to living in crisis. ... Building all over again was a constant. That's the way we survived periods of crisis." And Bodega López owner Eduardo López adds: "Argentina's constantly changing circumstances apply to all enterprises."³⁰ The whole *reconversión* process, which involved everything from replanting entire vineyards to focusing much of the industry – almost overnight – to the development of Malbec as an emblematic varietal, is reflective of people very much open to experimentation. In other words, perhaps because loss has become an expected part of life, some Argentines, in this case the protagonists of the wine industry, have become used to responding agilely to difficult situations and are willing, when necessary, to make risky decisions. "Our history tells us that there will be a crisis about every ten years, so we always have a Plan B, and it doesn't hurt to also have a Plan C."³¹

Another lesson from learned historical instability has been to hedge your bets. This tendency has been clearly manifest in the decision of nearly all of Argentina's most successful wineries to balance production and sales between international and domestic markets. Jose Alberto Zuccardi, who grew his international sales to 60 percent of production in 2006 achieving fastest export growth rate in the industry, nevertheless emphasized in a 2007 interview, "We live in this country and we know that at times there are ups and downs: it's good to be standing on both feet." The same sentiment was shared by Salentein Marketing Manager Matías Brandi who

explained in 2003 that the firm's goal was to shift from 60 percent domestic sales and 40 percent exports to 70 percent exports and 30 percent local market. "Although the shift is towards exports, the idea is to have balance."³²

Whatever the cultural components, the whole *reconversión* process has been marked with an extraordinary *agility* particularly beneficial to export growth. It has been matched by other forms of agility, in regulations and *terroir*, which have decisively added to the industry's success story. Like other New World areas, Argentine wineries have not been constrained by strict Denomination of Origin laws that in many Old World areas put limits on grape varieties, specific wine making procedures, labeling, etc. In essence, Argentine producers are free to grow their grapes, craft and sell their wines in accord with what they deem most important for types, quality and market preferences.³³

Equally, Argentine producers have access to a range of *terroirs* capable of yielding a diverse selection of wines. The country boasts the largest extension of vineyard lands in the world, spanning over 1,000 miles from north to south; altogether, they offer a wealth of temperature variations and altitudes. Indeed, various leading producers have carried out extensive experimentation, matching match grape varieties to specific micro-climates to attain a marked range of options within specific varieties. For the emblematic Malbec, this has led to a host of wines from straight-forward to complex. Additionally, the fact that vineyard lands are located in a veritable desert at the foot of the Andes allows for substantial manipulation of irrigation water to obtain desired wine outcomes. In terms of *terroir*, then, Argentines have many more options than most of their Old World counterparts and even than their Chilean neighbors whose vineyards are located in a much more Mediterranean-like region.³⁴

6. The Makers and Drinkers of Argentine Wine: Bridging the Gap

For Argentina's wine protagonists – vineyards, wineries, distributors – what has been truly revolutionary is the fundamental shift from a production-focused to a consumer-focused industry. In the first hundred years, decision-making revolved around grape prices, winery capacities, inflation, shifting exchange rates and preventing (or participating in) the watering of wine at the winery or at the point

of sale. Former Trapiche winemaker Angel Mendoza boiled it all down to, “the whole speculative game from the production perspective, without looking at all at the consumer.”³⁵

With the prospects of rapid export growth and a recovering and changed domestic market, the actions José Alberto Zuccardi demonstrate the newfound sensitivity to the “power of the consumer.” Signs placed throughout his winery read: “This project is entirely paid for by those consumers who choose our products.”³⁶ Adding substance to Zuccardi’s strongly voiced maxim, Margareth Henríquez, CEO of Chandon’s operations in Argentina, explained in a 2003 interview how her firm places the consumer at the core: “We have to get to know the wine drinkers better, understand what they want, interpret their new needs and adapt and develop products and services to respond to the new reality.” Long time industry observer Mariano González is even more concrete. He distills the convergence with consumers to four pivotal components: “establish Malbec as an umbrella brand through which each winery can organize its way forward;” “respond to the needs of the market ... seeking a balance between those needs and what the winery can offer;” “improve the price/quality ratio;” and establish “the image ... communicate the excellence of our wines to the world.” In sum, the task at hand is to develop an effective marketing strategy for Argentine wines.³⁷

As suggested by González, Malbec would become the key ingredient of that strategy. But its ascendance was neither always clear nor easy. As late as 2000, Malbec continued to be considered by most wine makers less promising than Cabernet Sauvignon, than Syrah and even than scarcely planted Pinot Noir. What was worse, as the Research and Marketing Director of the government’s Instituto Nacional de Vitivinicultura reported, still in 2000 Malbec vines were being pulled out to make way for new highways and housing developments. Despite being the most widely planted fine wine red grape, many resisted making it Argentina’s emblematic wine. Even industry leader Nicolás Catena initially overlooked Malbec, instead choosing the most established French varieties for his first premium wines: Chardonnay and Cabernet Sauvignon. After all, he explained in 1995, “the international criteria of quality ... are defined by the best French wines. The most expensive wines of Bordeaux and Burgundy have won that privilege.”³⁸

Catena’s view on the value of Malbec would soon change. Perhaps he remembered that his father and grandfather had dreamed

of making quality wines with the grape. Perhaps he began listening to his California consultant Paul Hobbs, his vineyard manager Pedro Marchevsky and his U.S. distributor Alfredo Bartholomaus who all advocated for an earnest endeavor with Malbec. Whatever the reasons, by the end of the 1990s he had become convinced of the varietal's potential and made it an integral part of his portfolio. Others, like Trapiche wine maker Angel Mendoza, cite Australia's success with Shiraz as decisive for establishing Malbec as Argentina's signature grape and for making wine with similar characteristics to Australia's market leader. "We identified our challenge at all the wine fairs. We tasted Australian wine, and we said: 'We have to change. If we want to adopt that model, we have to change.' We winemakers would go from stand to stand tasting and we would say, 'Look at the fruit, look at the color, look, this is the expression of the way wine should be made.'"³⁹

In succeeding years Malbec decisively left behind its lower status among Argentine wines, instead becoming the driving force for international success. In the words of importer/distributor Julio Suárez, "Malbec put us on the map worldwide." And as Catena's own export manager Cecilia Razquin explained in 2007, "For the first time ... there is a recognition of an Argentine Malbec fashion." Now the country's top wineries proudly stage expert tastings of their best Malbec bottlings at international wine shows such as the one led by arguably the world's most renowned wine advisor, Michel Rolland, at the 2005 edition of Bordeaux's prestigious Vinexpo.⁴⁰

Among a variety of explanations for Malbec's rise, two stand out. First, the varietal gives Argentina a unique identity in the wine world. "No-one else has Malbec like us," declares industry executive Sofia Pescarmona.⁴¹ As "new" as it is distinctive, Argentina's Malbec attracts that growing international market which seeks diverse wine experiences. Of course, diversity is one thing; producing an appealing wine is quite another. On that score, Argentine Malbec received an enormous boost from influential critic Robert Parker's 2004 pronouncement that it had attained "startling heights in quality" and his accompanying prediction – among the twelve he made for the following decade – that Malbec would ascend "into the pantheon of noble wines."⁴² And one need only read the list of enticing descriptors for Argentine Malbec over the past few years to recognize its considerable allure: "juicy, fruit-driven profile" "vivid purple and blue fruits: "lush, ripe," "sexy, supple texture" "fleshy yet

seductive” “flamboyant” “big and bold” “long and powerful”. Wines with these qualities certainly have intrinsic attractiveness. Moreover, they are prized by the increasing numbers of consumers who favor bold, highly concentrated wines, characterized by forward fruit flavors, high alcohol and limited notes of earth. In short, given the tastes of growing international market segments, Argentina’s Malbecs have gained considerable acceptance and visibility. Stories in the popular press about Argentine wine highlighting the virtues of Malbec abound: “Argentina: Malbec Becoming ‘It’ Grape” or “Mmm, Mmm Malbec!”⁴³

While Argentine wine makers have undoubtedly been influenced in export production decisions by the broad trend towards New World styles, they have undertaken only sporadic market research, largely limited to the purchase of surveys on overall consumption trends. Of course, many sought out international consultants for advice, not only about appropriate technology but also about market issues. Their counsel has undoubtedly played a major role in the development of appealing wines as well as for correcting defects. But Argentine wineries have had limited direct contact with their international clients, especially when designing new products. They have not, for example, generally supported controlled taste tests that might provide information on consumers’ reactions to the sensory qualities of prospective bottlings. Of course, even wineries that might want to carry out concerted research in export markets face severe impediments. In the United States, for instance, direct contact with consumers is made extremely difficult by the three-tier wine distribution system of producer, importer/distributor and retailer. Consequently, Argentine wineries have rarely obtained systematic information about the preferences of their potential and eventual customers.

What wineries may receive is informal feedback from importers and distributors. Veteran importer Alfredo Bartholomaus relates that he offers details on the taste preferences of the U.S. market to enologists at his affiliated wineries, “knowing what sells and what doesn’t in the U.S.” Patricia Ortiz, the CEO of Bodega Tapiz, acknowledges a somewhat greater influence, explaining that reactions from several international distributors convinced the winery to eliminate wood aging for Chardonnay altogether and to reduce it in their reds, especially by cutting back on American oak, in order to achieve fruitier and fresher flavors preferred by consumers.⁴⁴

Wine fairs constitute a venue where some wineries have sought out tangible responses from retailers and consumers. The value of these events for gauging preferences is, however, debatable. On the one hand, many of those who attend seem chiefly intent on trying as many wines as possible, infrequently entering into dialogue with exhibitors. At best, they may comment about wines they like, but not necessarily with complete sincerity; frank criticism of specific wines is exceedingly rare. For the trade, fairs are customarily dedicated to networking more than to evaluating specific wines. And as one prominent sommelier comments, especially when the winemaker is present – the person who would most profit from hearing a frank opinion –, “You don’t say much, so as not to make them feel bad.”⁴⁵

Nevertheless, some wineries spend substantial resources on tables and booths at fairs to “listen and learn.” When questioned about the above-mentioned limitations of these events for garnering useful feedback, importer/distributor Julio Suárez explains that not all fairs are equal. He claims that it is specifically at the upscale fairs, with high entrance fees and limited attendance, where his suppliers have been able not only to gauge the opinions of trend-setting consumers but also to “get their wines out” to this group.⁴⁶

Trips by journalists and retailers, underwritten by wineries and wine associations, are of even more questionable value for garnering substantive responses. As the owner of the largest U.S. chain of retail outlets specializing in Argentine wine observes, “The tactic of inviting trade people to Argentina has almost no market research value or even goal. People have good times, good wines, all free.” That a key part of the agenda is to pamper the visitors may actually be counterproductive in terms of receiving feedback. As our sommelier reflects, “After all, you don’t want to insult the people who feed you. So you can’t talk badly about anything.”⁴⁷

One area of market strategy where consumers, retailers and distributors have had significant impact is wine pricing, often provoking moments of tension. Prominent retailer Claudio Kosjuner remarks, “the wineries think you want to lower the price. They don’t trust you.” Nevertheless, producers are acutely aware that price can be a decisive factor in the decision to buy at all levels of the distribution chain. When Trapiche spokesperson Brigitte Barriero described the winery’s efforts to “tailor the wines to the U.S. market,” she referred not to the contents of the bottles but to their price points. Winemaker Angel Mendoza is more direct in his explanation. “The new

heads of the industry are the distributors and the supermarkets. They are the buyers. Now, today, we can't just go about happily setting the price of our wines. We have to be subject to the market."⁴⁸

Importer/distributor Suárez explains the system through which many if not most prices are established:

For pricing strategy, we start with the consumer price and back up. The distributor and the retailer taste the wine and give feedback on what they think it can sell for. Roughly speaking, the retail price of the wine is FOB X 3. If a distributor tastes a wine at, say, "FOB \$5.00 but says that it can sell for \$10.00 and not more, the winery must change its prices. If the wine is over-priced, I'm not going to sell it. In the low price range in particular – under \$10.00 wines – \$1.00 or \$2.00 is gigantic. \$1.00 can make all the difference."⁴⁹

Of course, as we have seen with the case of Argentine pioneer Nicolás Catena, one effective strategy was to price wines at a relatively high level to create expectations of quality. But even he admits that to achieve success "is a great challenge, because it is necessary to make wine with a price/quality ratio at least twice as good as the traditional brands."⁵⁰

When Catena began to export his Chardonnay and Cabernet Sauvignon in the 1990s, he and his peers were at a distinct disadvantage versus international rivals. The same overvalued currency that had subsidized the transformation of the industry made it difficult to compete on price against wines from other regions. This situation changed radically in 2001 when the country suffered one of the worst economic crises in the past hundred years. To large numbers of Argentines, it seemed that they were living in an "underdeveloping country" as poverty reached unimaginable levels, cutting deeply into the middle and working classes. But an attendant effect of the crisis was the breaking of the peso/dollar parity system; in short order, the peso descended from 1-to-1 with the dollar to 4-to-1, eventually stabilizing at 3-to-1. For the Argentine wine industry, the change in currency value could not have come at a better time. Those wineries that had been able to acquire state-of-the-art equipment and know-how with the strong peso, after 2002 took advantage of a weaker currency and low and declining land and labor costs to place their wines among the world's leaders in price/quality ratio. Luis Steindl, the CEO of Mendoza's Bodega Norton explains: "You

can get the same quality (of wine) as other areas, and the direct cost of production is probably one-quarter of what it'd be in the United States and even less than what it would be in France.” In the unvarnished verdict of industry newcomer Michael Evans, “You can make better wine here for less money than anywhere else in the world.” Journalist David J. Lynch’s conclusion is telling, even if only part of the story: “It is not complex noses or poignant bouquets that explain Argentina’s recent emergence in global wine markets, notably including the United States. It’s basic economics.” Tapiz’s Patricia Ortiz fundamentally concurs: “If the peso goes to one-to-one again, we’re dead.”⁵¹

What Lynch and others leave out of the equation is that those same favorable economic factors that help to keep prices moderate have also permitted producers to make substantial improvements in quality. The availability of a wide selection of excellent wines has been equally or more crucial than reasonable prices to the international competitiveness of Argentine wines. Particularly advantaged are the sales of lower and mid-priced wines retailing for under U.S.\$10 or between \$10 and \$30. Industry executives concur that these products are simply “unbeatable.”⁵²

While their low and medium-priced wines may be leaders in the international price/quality ratio battles, the Argentines have not overlooked the higher level products that were so influential at the beginning of the export endeavor. Aware of the impact of icon wines on the brand recognition of individual wineries and on brand/Argentina as a whole, various winemakers have dedicated considerable effort to producing bottlings that can both garner top awards at international wine competitions and the praise of influential critics from Robert Parker on down. Selling for up to US\$200, they share various features of vineyard management and wine making as well as high prices. Some of these include reliance on vines between 40 and 80 years old, highly controlled pruning and canopy management, the selection of the best bunches at harvest, manual separation of the grapes on special sorting tables, the use of special yeasts for fermentation and storage in new French oak barrels for extended periods. The results are reflected quantitatively in the point scores used in their rankings by two prestigious publications, *The Wine Spectator* and *The Wine Enthusiast*. The ratings of Argentine wines have jumped impressively over the course of the industry’s *reconversión*. In 1993, for example, the maximum attained

in *The Wine Spectator* was 89 points; in 2006 it was 95 points. For *The Wine Enthusiast*, the highest mark in 1996 was 87 points; in 2007 it had risen to 94 points. Also, three Argentine wines made both magazines' 2006 "Top 100 Wines of the World" lists. The enthusiasm for Argentina's icon wines is powerfully reflected in positive reviews that exalt them as "ultra rich," "very muscular," "so vivid, so pure, so full of pent-up energy." "They combine the best of both worlds – hedonistic style and authentic *terroir*."⁵³

One final form of communication from international markets concerns wine labeling. For label design, both front and back, producers have been highly sensitive to the particularities of specific markets. Their goal has been to design labels that communicate "mystique" and individuality while incorporating the most persuasive local "codes" of different market segments. Importers and distributors have had major participation in export labeling, providing decisive input on label designs and overall point of sale materials. As importer/distributor Suárez comments, "We are always in the loop." This process has resulted in an abundance of catchy labels at the entry level and more elegant, classy examples at mid and upper ranges. Examples of highly focused packaging include FECOVITA's creation of specific labels to target Hispanics in the U.S. and Bodega Tapiz's manufacture, at the insistence of the local distributor, of stylized bottle bags for the Japanese market.⁵⁴

Attention to label design is just one element of a growing drive to brand Argentina's wines. In this process, wineries have been particularly intent on distinguishing themselves from the bulk production of previous decades. Some have even changed their names in order to project a new and attractive image. Highly successful industry pioneer José Alberto Zuccardi, for example, converted his enterprise from La Agrícola into Familia Zuccardi "because La Agrícola gave the idea of something anonymous, of a cooperative. It didn't give the idea of a family structure, of a very personalized firm."⁵⁵

The concepts of "family" and "personalized" enterprises have taken physical forms over the past decade with the building of iconic wineries that dot the landscape of Argentina's wine regions. Various architects have gained strong reputations by translating brand identity into built structures. Nearly all of these new wineries incorporate attractive public spaces and use innovative forms of lighting to involve visitors in the production process while com-

municating the mystique of the wine. At the same time that these edifices have created high profiles for leading producers they have contributed to the rapid expansion of Argentine wine tourism. Since 2000 industry associations and various universities have been encouraging this process by launching well-funded studies to analyze the present and future of wine tourism, carefully mapping out wine routes and offering specialized training courses for winery personnel. These efforts are clearly bearing fruit; in 2006 alone, wine tourism increased by 45 percent. For the growing numbers of domestic and foreign tourists, wineries have begun to hire dedicated staffs, to hold special musical and arts events and to build restaurants and small hotels on the premises. Initially producers saw tourism mainly as a way to increase brand visibility. Subsequently it has become a means to augment wine sales; boutique wineries record up to 50 percent of income from this source, and the direct sales of larger firms have surged.⁵⁶

Wine tourism, new branding and labeling, high profile wineries, all-expense trips for importers and distributors, participation in wine fairs: all are components of an array of tactics pursued by individual firms and winery associations to advance their marketing efforts. Of particular note in recent years has been the series of ambitious advertising campaigns targeting international and domestic markets. For exports, an oft-repeated maxim of marketing consultants has been that continued growth hinges on the industry's ability to create a distinctive identity. The 2005 assessment of British expert Tim Atkin typifies these views: "What is needed is to 'sell yourself' as a country. This is such an attractive place, with so much culture and natural beauty ... but most people don't know it." Argentine wine executives agree. In the words of Peñaflor's Export Manager Juan José Canay, "you can sell much more than the wine itself. You sell its origins, you sell the country, you sell the culture of a place. If you create an image of good Argentine wine, you also create an image of Argentina."⁵⁷

Canay's proposal to build a country brand took concrete form in 2006 when Wines of Argentina, the leading industry trade group with a membership that controls 95 percent of exports, contracted with prominent local advertising agency González Taboada Guevara to design an advertising campaign for its principal markets – the U.S., the U.K. and Brazil – at a cost of US\$650,000. Three years earlier they had financed a market study on the strengths and weaknesses of

the image of Argentine wines in Europe and the U.S. Not surprisingly, tango, soccer and a series of attractive and identifiable vistas of the country were the most positive associations. The eventual campaign features ten large format color ads, “Unique landscapes, unique wines” to be placed in prestigious wine publications including *Wine Spectator*, *Wine Entusiast*, *Wine and Spirits*, *Food & Wine*, (U.S.) *Decanter*, (UK) *Wine Style*, *Adega*, *Prazeres da Mesa*, (Brazil) at a cost of up to US\$25,000 each. The ads highlight Argentine landscapes and cultural icons seen through a glass of wine.⁵⁸

The use of the country as the prominent element in wine branding is abundantly clear in the extensive picture gallery on the Wines of Argentina website. Of the 76 photos, 44 focus directly on wine, wine production, grapes or vineyards while 32 depict the richness of the land or show identifiable national symbols including tango, gauchos and beef. Two images that exemplify the brand/Argentina message portray men harvesting in the vineyards and a couple dancing tango. In the first, the laborers are covered in a hazy mist that fades the color of the picture, making its protagonists almost blend into the land and the vines, becoming part of the wine itself. The faded look of the picture communicates a feeling of antiquity, timelessness and tradition, of a place where things have always been done carefully and by hand. In the second photo, flanked by rows of barrels in a wine cellar, the two dancers are locked in a passionate embrace. The feeling and romance of the dance are meant to parallel those elements in the wine and to suggest that by drinking it one can experience the same emotions.⁵⁹

One final marketing tactic employed by several major producers has been to promote favorable reviews of their wines. Once again Nicolás Catena pioneered these efforts when in 2000 he decided to launch a new icon wine at a significantly higher price point than his previous bottlings. Following the recommendation of his international distributor Alfred Bartholomaeus, he sponsored a series of highly publicized blind tastings in the U.S. and the U.K., pitting his top Cabernet blend against some of the world’s most reputable wines including Chateau Latour, Haut Brion, Caymus SS and Opus One. His goal, to validate the wine’s quality and justify its price, was achieved; Catena was ranked first at seven of the nine tastings and placed second at the other two. A more commonly employed tactic has been to contract prominent public relations firms that undertake to introduce the wines to influential critics and obtain

hopefully favorable reviews. One way of achieving critical acclaim, according to some industry insiders, is to place ads in specific wine publications, thereby increasing the odds for a review and perhaps a few more points as well. However achieved, as Patricia Ortiz of Tapiz explains, the expectation is that reviews will make the wine “look serious,” elevate its visibility, and establish its legitimacy.⁶⁰

7. Argentine Wine Futures

Over the past decade the Argentine wine industry has undergone a veritable revolution, from the thorough upgrading of vineyards and many wineries to a dramatic improvement in the quality of its products. A major driver of these developments has been the decisive shift in emphasis from domestic consumers to export markets and the associated concern for devising effective marketing strategies. For an entire century after its founding in the 1880s, the wine industry formulated its business plans based on the perception of an undifferentiated mass of local consumers; during this period the concept of marketing itself was virtually non-existent. In contrast, the last decade has witnessed the agile responses of the country's leading firms to the challenges of new markets, proving themselves sensitive both to the distinctions between local and export markets and to a multiplicity of consumer segments. But will the Argentine wine industry be able to confront the future challenges of an ever changing international panorama with the same agility? While historians should never make predictions and even less suggest definitive answers, it is worth briefly outlining the major issues that will shape the future of Argentine wine and discovering what major industry actors are thinking.

The three key factors for maintaining export growth are the same ones that explain the progress of the past decade: competitive pricing; the strength of demand from external markets; and the identification of Argentine wines as special and worth drinking. The highly favorable price/quality ratio of Argentine wine has certainly been a crucial component of export success. In the present context, several suggest the persistence of this comparative advantage, while others appear to threaten it. On the plus side is the continued pegging of the peso to the U.S. dollar. If the dollar remains weak, so does the peso making Argentine wines relatively inexpensive at all price levels, particularly in comparison with those produced in European

countries tied to the stronger Euro. In past months, the Argentine government has devalued the peso at even a faster rate than the dollar's slide, the exchange rate slipping from approximately 3 to 1 to nearly 3.20 to 1. In large measure, this policy has been a response to a marked upswing in domestic inflation leading to increased costs for Argentine wine makers and for national industry in general. The specter of yet more severe price increases, harkening back to the days of hyper-inflation, and the real rise in expenditures for essential imports from Euro currency countries, principally French oak barrels and Portuguese corks, represents a genuine danger to the comparative pricing advantage that has been fundamental to the export growth of recent years.

The drop in the dollar presents still another problem for the Argentine wine industry: its possible linkage to a major downturn in the U.S. and perhaps in other global economies. It is encouraging that declines in real income in the U.S. have not yet been reflected in lower wine consumption. And given Argentina's price advantages, its wines should fare well even in more difficult economic times. Nevertheless, the specter of recession in their most important and fastest growing export destination has become an incentive for Argentine producers to seek new international markets. Induced by the economic slump following the 911 attacks, various firms had already begun to look for future growth in Asia and the non-traditional wine countries of Northern Europe. Also other Latin American countries are becoming attractive possibilities, above all Brazil with its enormous population, strengthening national currency and Mercosur free trade relationship with Argentina.

Economics aside, a driving force of Argentina's export boom has been the admirable quality of its wines, particularly the attraction of its emblematic Malbec. But given that its uniqueness is a key element of Malbec's appeal, is the wine's lure ultimately a temporary fad? Will consumers tire of Malbec in time? Should the Argentine industry continue to stake its fortunes largely on this one successful varietal, or should it seek to promote new wines on the international market?

Most experts voice optimism about the long-term prospects of Malbec. Among its enthusiasts are some of the wine world's most influential critics and consultants. Remember that Robert Parker hardly evoked the image of a passing fancy when he asserted that during the next decade Malbec would take its place among "the pantheon of noble wines." Parker's Argentine representative Jay Miller expressed similar

views on his recent visits to Argentina: “To conquer the market, Argentina should continue promoting Malbec. ... Malbec is what distinguishes Argentina within the multitude. ... Malbec is real, it is not something that will go out of style. ... Malbec has great room to grow, because from its entry-price wines on up you find very good options.”⁶¹ Renowned French consultant Michel Rolland is even more categorical in his support: “There is no reason for Argentina to change varietal. It is functioning so well with Malbec that I see no reason to try something else.”⁶²

That Malbec will most probably continue to be the driver of international sales does not mean that Argentine wineries have become complacent. Within the last three years export leaders, including Catena, Peñaflor (Trapiche) and Zuccardi to mention just a few, have begun to offer a broad range of diverse Malbecs at numerous price points from entry level to icon. High-end producer Catena, for example, has moved down, devoting substantial resources to the development and marketing of his economical Alamos line. Familia Zuccardi has gone in the other direction. Coming into the export market with largely entry-level products, the winery moved first to the mid-level with its Q line and most recently to an icon Z. Another sign of the search for diversity within Malbec has been Catena and Trapiche’s launching of expensive single-vineyard Malbecs featuring wines from high altitude vineyards with yields of 1 to 1.5 ton yields per acre. As Catena importer Bartholomew explains, “Since so many Malbecs are coming on the market, this is the way for Nicolás to continue to distinguish himself from the rest.”⁶³ Another emerging tendency is to establish the identities of a series of regionally specific Malbecs, from Salta’s high altitude plantings in the North to bottlings from the southern region of La Patagonia.

Sommelier Richard DiGiamcomo neatly sums up Malbec’s enduring prospects:

Malbec will get bigger and will achieve more icon status. It is the equivalent of California Cab which hasn’t gone out of style. That’s the model for Malbec. It’s not from anywhere else. It’s easy to pronounce. It’s full-bodied, great aromas, lots of berries like Cab, but more fruit-forward. It’s a safe wine. It’s easy to drink. People drink it and like it.”⁶⁴

ACKNOWLEDGEMENTS

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NOTES AND REFERENCES

1. Parker, R.M., Jr. (2005), *The World's Greatest Wine Estates*. New York: Simon & Schuster, 19.

2. Parker, *World's Greatest*, 19. Export statistics may be found at: <http://www.inv.gov.ar/PDF/Estadisticas/Exportaciones/2007/ComparativoH LFOB.pdf>

3. Víctor Honoré, "Argentina bate su record de exportación de vino a EEUU," *Argentinewine.com* (April 20, 2007); Miguel Angel Flores, "Vinos argentinos en EEUU: Entre marketing y mujeres," *Argentinewine.com*. (September 16, 2007).

4. Barros, R. (2007), "Millones con olor a vino," *Revista Fortuna: Negocios y Economía*, April 20.

5. González, M. (2007), "Crecen las exportaciones de vinos en un contexto global complejo," *Diario de los Andes* May 17.

6. "EE.UU. sería en 2008 el primer consumidor mundial de vinos," <http://www.diariouno.net.ar/2007/01/28/nota137102.html>.

7. Australia's importance was emphasized, for example, by Alberto Arizu, Commercial Director of Bodega Luigi Bosca, Interview, August 2003. Also, the highly successful wine duo Susana Balbo and Pedro Marchevsky call the Australian model "a paradigm," that really opened our minds." Quoted by Mariano González, "Bodega Dominio del Plata: Dos sueños, dos estilos, una familia," *Vinos y viñas*, # 990 (April 2004), 43. Actually, the Shiraz case exhibits differences as well as similarities with Malbec. Shiraz is not a "new" variety, rather something of a new name and new style of a well recognized Old World grape, Syrah. In the Argentine case, Malbec was an almost unknown grape from Southwestern France (Cahors) with very limited use and success, especially when compared with other major French red varieties such as Syrah or Cabernet Sauvignon, Merlot, Pinor Noir and even Cabernet Franc. Another model similar and roughly contemporaneous with Malbec in Argentina is Sauvignon Blanc in New Zealand. But once again, it follows more closely the Australian case with the promotion of an already established and greatly successful variety in France that has seen somewhat less success in New World regions such as California.

8. "Vino's Twin Peaks: Mendoza and Santiago," *The Economist* (March 17, 2007): 44. As Argentine wine commentator Diego Brando has explained, part of Chile's problem with the promotion of Carmenere originates from the fact that it is a difficult grape to produce in large quantities, and in any case Chile continues to plant small quantities of Carmanere as compared to its export anchors Cabernet Sauvignon and

Chardonnay. “Vinos: Conquistar mercados.” *Latitud2000* (January 29, 2008). http://www.latitud2000.com.ar/index.php?option=com_content&task=view&id=7230&Itemid=442008-01-29.

9. Hobbs first experienced these wines when he traveled to Argentina in 1983 to consult for Nicolás Catena. Quoted in Dereck Foster, *Revolución en el mundo de los vinos* (Buenos Aires: Ennio Ayosa Impresores, 1995), p. 64. Sources on the “Argentine taste” include Pablo Minatelli (vineyard manager of Bodegas Norton), Interview with the Author, August 2003; Luis Coria, Interview with the Author, August 2003; Paul Caraguel (French manager of Bodegas Chandon), Interview, November 17, 1999, provided by Bodegas Chandon.

10. Quoted in *Bodegas & terruños*, 6 (May 2000), 28.

11. *Bodegas & terruños*, 2, 1999: 18–19. Emphasis in the original.

12. Angel Vespa, “El desafío competitivo,” *Vinos & viñas*, 991 (August 2004): 11.

13. On changes in the content of wine exports see: <http://www.inv.gov.ar/PDF/Estadisticas/Exportaciones/2007/ComparativoHLFOB.pdf>.; *Vinífera, Revista del Instituto Nacional de Vitivinicultura*, I:4 (1996), 12. Javier Merino, “LA EXPORTACION DE VINOS TRANSFORMO AL SECTOR,” *Bodegas y terruños*, # 3 (October 1999), 6. While the recent export boom has clearly represented a departure for the industry, there have been limited and largely failed attempts in the past, one of which was undertaken by Vinos De la Argentina, a consortium of firms in the 1970s led by Peñaflores’s Trapiche winery.

14. Interview with the Author, June 2005. On Catena’s pre-1980s experience, see: Foster, *Revolución en el mundo de los vinos*, 25 and Paul Franson, “Nicolás Catena the “Bob Mondavi” of Argentina,” *Wine Business Monthly* (October 2003). <http://www.winebusiness.com/html/MonthlyArticle.cfm?dataid=27902>

15. Quoted in Foster, *Revolución en el mundo de los vinos*, 33.

16. Alejandro Walters, “Rebuilding Technologically Competitive Industries: Lessons from Chile’s and Argentina’s Wine Industry Restructuring.” (Ph.D. Dissertation, Department of Urban Studies and Planning, MIT, 1999), 68–69.

17. Interview with the Author, June 2005.

18. Juan José Canay, “Argentina necesita posicionarse como país en el mundo del vino,” *Bodegas y terruños*, 6 (May 2000): 10 and *Argentine-wines.com*, January 31, 2007. While in many ways Peñaflores’s business strategy paralleled that of Catena, there have been some interesting divergences. Former Trapiche wine maker Laureano Gómez explained a major one: “Catena had a great advantage over us, because just as he got rid of his table wine brands, Peñaflores didn’t have a better idea than go and buy them. A visionary gets rid of table wine, and Peñaflores keeps growing by buying table wine brands.” Interview with the Author, June 2005.

19. On the decline in acreage see: Daniel Aspiazu and Eduardo Basualdo, *Estudios sectoriales. Componente: Industria vitivinícola*. Buenos Aires: CEPAL-ONU, 2003, 10–12; Javier Merino, “Reconversión agrícola: Nuestros viñedos comienzan a parecerse a los del mundo,” *Vinos & viñas*, 990 (April 2004): 14.

20. Interview with Author, August 2004.

21. Interview with Author, August 2003.

22. Interview with Author, August 2004.

23. On the Menem policies and industry investments, see Daniel Aspiazu Eduardo Basualdo, *El complejo vitivinícola argentino en los noventa: Potencialidades y restricciones*. Buenos Aires: CEPAL, 2000. Also useful is Rodolfo Richard Jorba, “Cambios tecnológicos y transformaciones económico-espaciales en la vitivinicultura de la Provincia de Mendoza (Argentina), 1870–2000,” *Scripta Nova, Revista electrónica de geografía y ciencias sociales*, Universidad de Barcelona, 69/83 (August 1, 2000): 12. Alberto Arizu of Bodegas Luigi Bosca explained the attractive credit situation in an Interview with the Author, August 2003. On comparative land prices, Olly Wehring, *Argentina Wine Industry Review* (Bromsgrove, United Kingdom, July 2006), 17 and Javier Merino, “Fincas baratas?” *Argentinewine.com* (March 24, 2007), provided useful information. On future investment, see PricewaterhouseCoopers, *From Sao Paulo to Shanghai. New consumer dynamics: the impact on modern retailing. Executive Summary 2006/2007*. [http://www.pwc.com/Extweb/pwcpublications.nsf/docid/DD3BFAFBAE31B5FD852571FE005C9AE2/\\$File/argentina.pdf](http://www.pwc.com/Extweb/pwcpublications.nsf/docid/DD3BFAFBAE31B5FD852571FE005C9AE2/$File/argentina.pdf)

24. Sophie Jump quoted by Wehring, *Argentina Wine Industry Review*, p. 25. On the use of imported clones see Raúl de la Mota, quoted in Foster, *Revolución en el mundo de los vinos*, 50. The rise of local and foreign nurseries is chronicled by Carmen Pérez, “Para la vitivinicultura el vivero es la llave del futuro,” *Bodegas y terruños*, 3 (October 1999): 40–41; Miguel Angel Flores, “Los viveros vitivinícolas en Mendoza: El primer eslabón de la viticultura,” *Gerencia vitivinícola*, 2 (August 2000): 40–45; and Hernán Ojeda, Carlos Catania and José Rodríguez, “Selección clonal del Malbec,” *Idia, Revista de Información Sobre Investigación y Desarrollo Agropecuario (INTA)*, 1/1 (November 2001): 47–52. On irrigation see Aspiazu and Basualdo, *El complejo vitivinícola en los noventa*, pp. 139–140. On the level and pace of the technological advance in general see: Aspiazu and Basualdo, *El complejo vitivinícola en los noventa*, 138–39. Specific information on the pioneering wineries in the technological transformation was obtained from Angel Mendoza, Interview with the Author, June 2005; Paul Hobbs, Interview with the Author, August 2004, Jeff Mausbach, Cecilia Razquin, Leandro Juárez and José Galante, Interview with the Author, August 2003; Nicolás Catena, quoted in Foster, *Revolución en el mundo de los vinos*, p. 29; Francisco Martínez, Interview with the Author, August 2003; and Adriano Senetiner cited by Silvina Carbonari, “Vinitera, típicos vinos de ‘terrior,’” *Master Wine* 5/38 (2004): 32. Eduardo López, of Bodegas López, com-

mented that in 2003 his winery had installed the fastest bottling line in the Americas, Interview with the Author, August 2003.

25. An excellent list of international consultants is presented by Tim Atkin, “No Going Back,” *Harpers Wine and Spirit Weekly* (May 1, 2002). See also Gerald A. McDermott, “The Politics of Institutional Renovation and Economic Upgrading: Recombining the Vines that Bind Argentina,” *Politics and Society*, 35/103, March 2007: 113, 129 and 142. On the marketing consultants, see María Soledad González, “Las llaves para desarrollar una marca exitosa,” *Vinos y viñas*, 992 (December 2004): 74–75.

26. Mario Domingo Rodríguez, “El ‘Gran Buenos Aires’, extraordinario consumidor de vino,” *Anuario vitivinícola 1973*, 38–40. Even though part of a global phenomenon in traditional wine drinking countries, the 2/3 drop in Argentina in the space of some two decades made it a particularly extreme case. On general consumption trends, see INV <http://www.inv.gov.ar>.

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28. It is important to note that the Chileans do not have not have the same cushion as Argentina in terms of domestic consumers. With a relatively weak national market where the custom of wine drinking does not have strong roots in comparison to its trans-Andean neighbor, it is more difficult to make the risky choices.

29. On the shift to quality in domestic consumption, see: Ana María Ruiz and Hernán Vila, “Cambios en la demanda de vinos en el fin del milenio,” *Idia, Revista de Información Sobre Investigación y Desarrollo Agropecuario (INTA)*, 1/1 (November 2001), 44; and Hugo Centrángolo, Sandra Fernández, Javier Quagliano, Vera Selenay, Natalia Muratore and Francisco Lettieri, *El negocio de los vinos finos en la Argentina* (Buenos Aires, Editorial Facultad de Agronomía Universidad de Buenos Aires, 2002), 62. Zuccardi quoted in “Vino argentino: Exportar más para seguir creciendo,” *Diario Los Andes* (September 7, 2006).

30. Alberto Arizu and Eduardo López quoted in Gabriela Malizia, “Bodegueros de pura sangre.” *Los Andes Online* (April 26, 2008) <http://www.losandes.com.ar/notas/2008/4/26/fincas-355597.asp>

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33. State regulations that do exist include set the dates for the end of harvest, a minimal time for the release of new wines, and the minimum percentage of alcohol for the product to be considered wine.

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37. Quoted in María José Barber, "Margareth Henriquez-Ceo de Chan-dón: La crisis es una fuente de permanente aprendizaje," *Vinos y viñas*, 986 (September 2003): 28. The three-pronged strategy was suggested by Mariano González, "Agasajo vendimial: La esperanza desbordó las copas en la fiesta del vino," *Vinos y viñas*, # 984 (May 2003), 22.

38. Catena quoted in Foster, *Revolución en el mundo de los vinos*, 32.

39. Information on Hobbs and Marchevsky obtained from Hobbs, Interview with the Author, June 2005. Bartholomaeus's role was outlined in an Interview with the Author, April 2008. Angel Mendoza's statement from Interview with the Author, June 2005. See also: Cristina S. Pandolfi de Fernández, "El Malbec en cifras: Una realidad para reflexionar," *Gerencia vitivinícola*, # 2 (August 2000), 26.

40. Suárez, Interview with the Author, April 2008. Razquín quoted in María Soledad González, "El vino argentino gana adeptos den el mundo," *Diario Los Andes*, June 30, 2007. <http://www.losandes.com.ar/notas/2007/6/30/fincas-234533.asp>.

41. Quoted by Simon Meads, "More than Malbec," *Wine International Tasting* (May 2004).

42. For Parker's views, see Robert M. Parker Jr., "Parker Predicts the Future," *Food and Wine* (October 2004), <http://www.foodandwine.com/arti-cles/parker-predicts-the-future>. As part of his prediction, Parker explained that Malbec, originally from Southwestern France, had "failed miserably on its home soil," producing largely harsh, acidic, often sour wines.

43. *The Wine Advocate*, No. 174, December 2007. Malbec descriptors were culled from: *The Washington Times* (November 2, 2005); and *The Wine Spectator* (November 30, 2006), 93 and (December 15, 2007), 115. The article titles are taken from *Wine Country International*, (March 3, 2005) http://www.billingtonwines.com/admin/images/imgpress/wci_mmmmmmmalbec0205.pdf and *Golfweek* (March 32, 2008). <http://www.golfweek.com/lifestyles/features/story/argentina-wine-feature-033108>.

44. Alfredo Bartholomaeus, Interview with Author, April 2008 and Patricia Ortiz, Interview with the Author, April 2008. On the scantiness of direct market research see Miguel Angel Flores, "Vinos argentinos en EEUU: Entre marketing y mujeres," *LosAndes online* (September 16, 2007). [Http://www.losandes.com.ar/notas/2007/9/16/economico-242066.asp](http://www.losandes.com.ar/notas/2007/9/16/economico-242066.asp). A contrary view was expressed by Mario Giordano, coordinator of the trade group Wines of Argentina, who referred to "enormous research projects in several countries around the world in order to find out how people view us: What

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46. Julio Suárez, Interview with the Author, April 2008.

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53. Information on wine publication ratings was obtained from: McDermott, “The Politics of Institutional Renovation & Economic Upgrading: Lessons from the Argentine Wine Industry,” 40; and an examination of the issues of *The Wine Spectator* and *The Wine Enthusiast* for 2006 and 2007. Specific reviews may be found in James Molesworth, *The Wine Spectator* (May 15, 2007): 144 and *The Wine Spectator* (October 15, 2007): 134; “Argentina’s New Summits: A Wine Industry Looks Abroad to Discover Itself,” *The Wine Spectator* (November 30, 2004), 61; and Molesworth, *The Wine Spectator* (January 31–February 28, 2007), 85; and *The Wine Enthusiast* (August 2007), 64. A succinct explanation of the production components of Argentina’s icon wines is contained in Mariano González, “Vinos de alta gama y sus autores: Llegaron a la cima pero van por más,” *Vinos y viñas*, No. 984 (May 2003), 31–32.

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56. On winery architecture see: Silvina Cabonari, "La nueva imagen de las bodegas mendocinas," *Bodegas y terruños*, # 6 (May 2000), 30–33 and Germán Sala, "Bodegas con personalidad," *El vino & su industria*, II: 8 (April 2003), 45-48. Information on tourism is contained in: "Bodegas de Argentina presentó su informe de turismo vitivinícola," *Argentinewines.com*, March 5, 2007; "II Curso de Diseño y Organización de Rutas Alimentarias y de Turismo del Vino," *Argentinewines.com*, September 20, 2007; "Bodegas de Argentina presentó su informe de turismo vitivinícola," *Argentinewines.com* (April 5, 2007); "Diagnóstico sobre turismo del vino en Mendoza," *Argentinewines.com* (May 5, 2007), and Lynch, "Golden Days for Argentine Wine Could Turn Cloudy." An example of wine tourism courses is "II Seminario Internacional Turismo del Vino," <http://www.seminariode turismo.com/>.

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58. Information on the campaign is contained in: "Los paisajes y vinos argentinos tienen ese que se yo ¿viste?" *Vinos al mundo* (November 11, 2004). http://www.vinosalmundo.com/Ver_Articulo.asp?id=252; Alberto Borriñi, "Se lanzó una campaña orgánica del vino argentino en el exterior," *ExportaPymes* (August 7, 2006). <http://www.exportapymes.com/article3428-Se-lanzo-una-campa%C3%B1a-organica-del-vino-argentino-en-el-exterior.html>; Gustavo Sencio, "Quieren cuadruplicar la presencia de vinos argentinos en el mundo," *Diario Los Andes*, September 10, 2006. <http://www.losandes.com.ar/notas/2006/9/10/economico-206927.asp>; and Hernán Fernández, "Los cortes del vino," *Infobrand: Revista de marketing, branding y comunicación*, August 22, 2006. www.infobrand.com.ar/nota.php?id=7803.

59. The analysis of the picture gallery and the images at <http://www.winesofargentina.org/galeriadefotosing.html>, was suggested by Grant Lachman.

60. Details on the Catena tastings in the UK and the US are in documents received from Alfredo Bartolomaus and substantiated by Bibendum on their website, www.bibendum-wine.co.uk. Bartolomaus was very informative on the whole process, Interview with the Author, April 2008. Patricia Ortiz detailed the Tapiz experience in an Interview with the Author, April 2008. Matías Brandi, former U.S. Marketing Manager at Bodegas Salentein explained in a 2003 interview that the lion's share of the firm's publicity budget was paid to public relations firms specifically with the goal of having Salentein's wines reviewed in major publications.

61. Interviews with Jay Miller, *Area del vino*, (June 28, 2007). <http://areadelvino.com/>; and María Soledad González, "Qué dejó la visita de Jay

Miller en Mendoza?" (April 24, 2008). <http://www.areadelvino.com/ContenidoArticulo.aspx?PID=8278>.

62. Quoted in Alfredo Sainz , El "gurú" del vino considera que, a la hora de exportar, las bodegas argentinas tienen que seguir confiando, ya que los millones están en el malbec," *La Nación.com* (April 20, 2008). http://buscador.lanacion.com.ar/Nota.asp?nota_id=1005836&high=micel.

63. Interview with the Author, April 2008.

64. Interview with the Author, April 2008. Despite the confidence in Malbec, various wineries hope that Malbec will open the door to their other wines including excellent Cabernet Sauvignon, Merlot and Syrah. Additionally, numerous Argentine producers are experimenting with the production and sale of new varieties unique to the region including the white grape Torrontés and another red variety, Bonarda.

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CIVILIZING THE MARKET ECONOMY: THE APPROACH OF INTEGRATIVE ECONOMIC ETHICS TO SUSTAINABLE DEVELOPMENT

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ABSTRACT. As long as the economy is not embedded in a superordinate societal framework the problem of sustainable development cannot be solved within the logic of the market system. The establishment of such a framework is an epochal cultural and political task. The well-known definition of sustainable development by the Brundtland Commission fails to make this clear since it neglects the importance of interpersonal obligations (rights and duties). But from an ethical perspective, interpersonal obligations are essential. The discourse on sustainability is dominated by the technocratic illusion that more “eco-efficiency” of our economic means is enough and that the purposes of our economic activities need not be put into question. Contrary to this illusion, it is argued here that we need to develop a socio-ecological understanding of the problem and to recognize that “sustainable development” after all is just another term for establishing social, international and intergenerational fairness and justice. After raising the awareness for this understanding in the first section, the second section of this paper presents a problem-solving approach that includes four elementary steps of rethinking and establishing socio-ecological policies by means of limiting the inherent necessities of market competition.

JEL: A11, L17, Q01

1. Raising the Awareness of the Problem: Why Sustainability Is an Economic-Ethical Challenge

1.1 Political Ecology: the Social Conflict between the Economy and the Environment

“Our generation has the chance to reconcile the *social* reality with the *ecological* preconditions on our spaceship called earth through *political* action.”

For me, this is one of the key sentences in the NAWU report from 1978 (Binswanger et al., 1978, p. 14, italics PU). Even though the statement was too optimistic as a prognosis, as a normative programmatic statement it very precisely captured an essential insight: there will be no sustainable economic development as long as it is not embedded in a superordinate societal context – and it is a *cultural and political* task to ensure this embedding.

From this point of view, the magic word “sustainable development” might inhibit the consciousness for the enormous task that we face rather than promote it. Why is that? The standard definition (according to the Brundtland Commission in 1987) states: “sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs” – but this is terminologically confined to *teleological* categories of resources and goods, that is, it focuses on needs and on the means for satisfying them. The *deontological* categories of interpersonal obligations (rights and duties) are not as evident in this definition. But it is exactly the deontological point from which an ethical reflection ensues (Diagram 1).

Which needs and whose needs are meant by the term “the needs of the present”? Is the growth of these needs which goes along with the growth of the economy really the right standard for a sustainable development? Can these needs, if we accept them uncritically, even be reconciled with sustainable development? Does sustainable development boil down to the motto: We need economic growth, but it may and should be “qualitative”? If we think like that we presuppose that sustainability and economic growth can be harmonized in a technical-instrumental way. This stance is quite popular because it obviously allows us to uncritically hold up economic growth as a goal. Believing that “sustainability needs” and economic growth can be combined without any problems frees us from the need to reorient ourselves politically and economically.

Such economic policy does not eliminate but merely “modernize” the symptoms of poverty and existential needs: economic growth does not automatically or “naturally” enable us to break out of an “economy of poverty”. Instead, we can only break out of this “economy of poverty” if we consciously cultivate and *fairly organize* the social use of economic growth (Ulrich 2008: 185ff.). Or, put differently: economic growth (quantity) can never replace a just social order (quality).

Yet, I would like to emphasize that I do not want to condemn economic growth as such. On the contrary, the task is to promote growth that we can deem legitimate according to life-practical criteria. In this regard it is important that we focus on the social and ecological conflicts that are inherent in economic growth as a cause. Instead of doing this, we currently tend to focus on end-of-the-pipe approaches which merely touch the symptoms of economic growth.

1.2 Sustainability as a Question of Justice

Why is the formula “sustainable development” so widely accepted? I argue that the surprisingly broad consensus on “sustainable development” derives from the fact that sustainable development *seemingly* resolves the many social conflicts between private economic interests, ecological aspects and existential needs of the people. The very popular “triple bottom line” (Elkington 1999) is symptomatic for this view: the triple bottom line suggests that the three dimensions of sustainable development can be *added* up without any problem and that ecological and social acceptability can be harmonized with the existing economic system. However, as soon as we acknowledge that there are conflicts between the ecological, social and economic dimension, we realize that the normative problem now just concerns the *weighting* of the three criteria.

Let us briefly reflect where there is in principle harmony and where there is conflict between the social, the ecological and the economic dimension. We can distinguish two fundamental problems:

- *Harmony* between economic growth and ecological as well as social criteria becomes particularly manifest in the *poverty-driven environmental destruction* in third world countries (e.g. deforestation in order to get firewood due to a lack of other energy supply). If poverty could be eliminated through economic growth from which broad levels of the population and especially the poorest benefit,

these people would not be forced anymore to deforest local woods in their daily fight for survival. And let us note: this concerns their present not their future needs. Such economic growth would mean that we get down to the socio-economic root of this environmental destruction – through good development aid.

- In contrast to this, a *conflict* with ecological and social criteria exists in the case of *environmental damages that are caused by wealth*. The tendency that ever widening sections of the population consume almost as much as the wealthy people causes an increase in energy and environmental consumption – this is true on a national as well as on a global level (think for example of the ecological horror vision if every second Chinese or Indian drives a car). The burden for us, the privileged Western Europeans, in this context is: our energy- and resource-intensive level of wealth cannot be generalized in a global scope. In the long run we could only maintain our level of wealth through a violent oppression of the South for a limited period of time. But if the rich and mighty OECD countries want to avoid the danger of violent oppression and if they want to promote a peaceful and more or less just living together of all people on this planet, we, and particularly the richest among us, have to restrict our own aspirations. Are we really up to this, individually and politically?

What is open to debate, are core ideas of a *legitimate form of life and societal order*, which finally determine how we treat the environment, individually and collectively. The justification of models of a sustainable development that can be legitimized towards everyone is therefore, as mentioned, an ethical or even economic-ethical task, also with regards to ecological aspects. It is a technocratic illusion that we only have to increase the ecological efficiency of our economic *means* but that we do not have to increase the sustainability of our economic *ends* (Ulrich 1997): Against this illusion, we have to understand the problem as an inherently socio-ecological one (Diagram 2): ecological scarcities do not exist *per se* but they result from normative ideas of the good life, and they are therefore always – and increasingly – in the spotlight of social conflicts of values and interests.

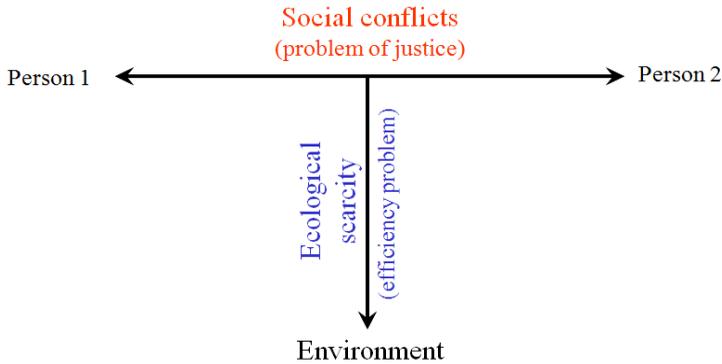


Diagram 2: The two dimensions of the socio-ecological problem

As symbolized by this T-model, all ecological scarcities are embedded into social conflicts. Our foremost systematic task is to use these scarcities reasonably. This task cannot be resolved within the category of efficiency because it concerns *our ethical reason* that relates to the reciprocal respect and recognition of the people and to the fair consideration of legitimate claims of everybody on three levels – within a society, internationally and intergenerationally.

From this perspective, “sustainable development” is in the end just a different, almost euphemistic or trivializing term for what denotes *the equal rights* of all human beings in respect of scarce natural resources. The realization of these equal rights is of course still far away. But in any case, sustainability requires a normative concept which implies the obligation to *embed* the responsible use of natural resources into a just *societal order* – and I emphasize *societal*, not just economic order.

2. A Problem-solving Approach: Socio-ecological Politics of Limiting Inherent Necessities of Market Competition

If we observe economic-political debates nowadays, we notice that they are persistently dominated by the rhetoric of “economic necessities”: “We have no choice... global competition forces us...” Thinking in terms of inherent market necessities prevails! Real inherent necessities can, however, only be found among natural laws; in our life-practice the *established* (systemic) inherent necessities after all derive from *intellectual blinkers* that rest on normative pre-

sumptions and that are institutionally solidified. And this means in practice: the superficial inherent necessities can be dismissed if we free ourselves from the mental constraints that lie at their roots (Ulrich 2008: 115ff.). In order to free ourselves we just have to ask for *good reasons* for the existing practice, respectively for the *reform* of this practice. “Reform” here does not mean that we should further *release* the logic of inherent necessities as promoted by the market economy, but rather that we should envision new starting points for a life-serving politics that *restricts* those inherent necessities. I suggest four elementary steps in order to arrive at such politics.

2.1 Against the Economistic Reversal of Ends and Means

First of all we have to understand economic activity consequently instrumentally. *Rational economic activity* is not an end in itself, but a *means* for our good life and our just social life. In principle we can emancipate ourselves at least *partially* from the economic logic of inherent necessities, in our private life as well as in our ‘public use of reason’ among mature citizens:

- On an *individual* level, as persons of integrity, we can and should renounce on the maximization of our economic success (profit, income, consumption...) and instead *limit ourselves* in two aspects: a) with regard to what is *conducive* to our own cultivated life project, and b) with regard to social and ecological “externalities” that are socially and intergenerationally generalizable and thus *responsible*. Such individual self-limitation, however, can only be reasonably demanded from individuals in a limited sense since individuals have to assert themselves in the competition in order to earn their income. Therefore the fair integration of individuals into economic production processes is equally important as their freedom to emancipate themselves from the inherent necessities or the intellectual blinkers of the capitalistic market economy. Behind its alleged inherent necessities, almost always interests in the profitable utilization of capital can be unmasked in the end.
- Only on a *collective* level, we can at least partially limit these necessities. I assume that we also only *want* a partial limitation – because as far as incentives to utilize capital are useful for the general welfare, we probably want to conserve the highly efficient system of the market economy. But this welfare should be socially and intergenerationally generalizable, otherwise it is rather part of

the sustainability *problem* and not of its solution... At the same time also the popular argument that economic growth creates jobs is not sufficient. Wasn't the relation between production and consumption meant to be reversed, that is: work as a means, and meaningful material wealth and life quality as a goal? Hasn't the (assumed or effective) economic-political goal to restore the state of full employment become questionable also from an ecological point of view? In order to quote again from the initially mentioned report:

“If nothing *meaningful* is being produced, the generation of a high domestic product just in order to achieve full employment is worse than a lower domestic product with more spare time but a higher quality of life.” (Binswanger et al. 1978, p. 149; my italics)

But what if economic reasons (that is productivity reasons) and ecological reasons (that is the limits to growth) force us to dismiss the goal of full employment as an intended normal state? Do we have a modern alternative to the idea that everybody should secure his or her income on the labour market and that economic growth is indispensable for a highly productive, post-industrial society? I cannot enter this question at this point. Maybe we can come back to it in our discussion. Right now I would like to clarify some systematic pre-conditions.

In general, we have to overcome the tendency to *reverse means and ends*, that is, we have to stop to subordinate all life-practical needs to the economic logic. And this is not possible *within* the real existing logic of the market economy, because in this system the goal (namely, the maximum return on equity) and the means (namely, everything else) are already predefined. We have to use the logic of the market system more consequently as an efficient means for achieving a socially and ecologically sustainable form of progress. Also here we have two points from which to start: a) by means of an intelligent, market conform politics of incentives and disincentives, we can influence the *direction of impact* of the market's inherent necessities so that they become beneficial not only in an economic but in a superordinate sense. And b) we can constitutionally limit the *scope of effectiveness* of market competition in areas where the efficient utilization of capital is not an appropriate coordinating principle for achieving the superordinate goals. This conforms to the idea that areas where we rely on the market as a societal coordination mechanism must be judged according to market performance – but

there is no reason to believe that we should rely on the market as a coordination mechanism in all areas of life!

2.2 Two-tiered Regulatory Politics: Competition Politics plus “Vital Politics”

These remarks have already prepared the second reflective step for dissolving our usual economistic intellectual blinkers: we need a *two-tiered conception of a good regulatory politics* (Ulrich 2005: 167ff.). This reminds us of what has been postulated in principle by the ordoliberal thinkers with a humanistic orientation, namely Wilhelm Röpke (1960) and Alexander Rüstow (1955: 74): we need to conceive of a good political order as a connection of superordinate “vital policy” (nice term, isn’t it?) and competition policy – the latter is just as important but systematically subordinate to vital policy (Diagram 3).

In order to avoid that the economic efficiency becomes an inherent necessity or an end in itself, we have to use economic efficiency consciously *with regards* to the vital-political standards. Hence, the goal is not to achieve compromises between economic and life-practical criteria but rather to switch from a horizontal to a vertical perception of the problem and to become aware of the right order of aspects. It is essential that we do not perceive socially and ecologically motivated standards as annoying external limitations of our economic dynamics and of the “economic rationality”, but that we instead perceive them as a *precondition for the legitimacy* and as a *horizon of the meaning* of a truly efficient and life-practically *reasonable* economic development. (An example may be the latest expert report from the UN agricultural council: it signalizes a change of thought towards an agriculture that adapts itself to cultural and regional characteristics and so promotes the conservation of soils, forests and water sustainably).

<p>1. Vital policy (A. Rüstow) = embedding the market economic system “within a higher order of things which is not ruled by supply and demand, free prices and competition” (Wilhelm Röpke 1960: 6) = design and limitation of the “blind” market forces according to ethical aspects of <i>the service of life</i></p>
<p>2. Competition policy = imposition of open markets and effective competition <i>within the scope</i> of the vital-political standards = efficient use of competition in the market economy <i>for</i> “vital” ends</p>

Diagram 3: Two levels of an ordoliberal regulatory politics

Economic rationality, understood in an unabbreviated sense, is to be seen as a kind of a magical triangle between efficiency, meaning orientation, and justice in which efficiency is subordinate to the other angles for inherently logical reasons (Diagram 4).

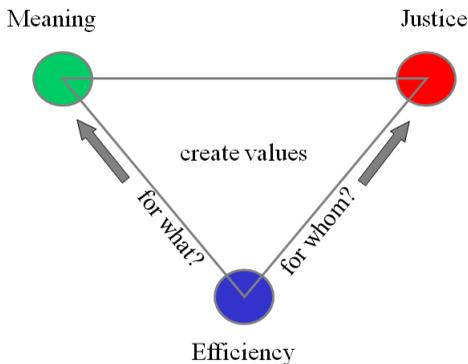


Diagram 4: A magic triangle of reasonable economic activity

The adequate participation of all members of society in the domestic product that has been generated collectively and through divided labour cannot be achieved through economic growth that is not subject to any criteria, but rather through contemporary *economic citizenship rights* and *cultivated life projects*. (If this slide is too coloured for you, please note that the colours have not been chosen haphazardly.) But let me proceed to the next solution for dismissing our intellectual blinkers.

2.3 Horizon of Progress: A “Civilized” Market Economy

The horizon of a socio-economic development in the service of life could consist in a literally *civilized market economy* (Diagram 5) that is consequently embedded into a fully developed civil society – as a means for a good life and living together of free and equal citizens. This third way in principle leaves the ideological 20th century debate about systems with the idolization of the market on the one hand and the idolization of the state on the other hand behind. Instead, priority is given to *really free citizens*, not just to the “free market” – free of what is the market supposed to be then? (It is not possible to develop the whole foundations of “civilizing” the market economy here; instead, I allow myself to hint at my English book *Integrative Economic Ethics: Foundations of a Civilized Market Economy*, which has come out in Cambridge University Press in 2008.)

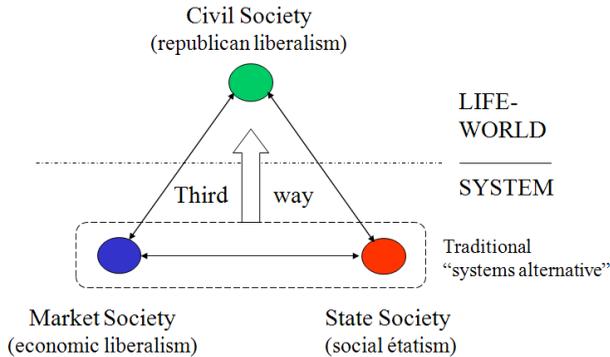


Diagram 5: Third way between idolizing the market or the state: “civilized” market economy

To make it simple: It is important that we overcome the puberty-like period of an overly autonomous economic system and that we learn to reorganize the perverted relationship between market economy and civil society. Civilizing the market economy certainly requires an epochal cultural and political learning progress. We have the epochal task of thinking about the new chances of good life and living together that the incredible productivity of modern economy could offer us within a well-ordered (world) society – if only we are reasonable enough.

No less a figure than the great and nowadays rediscovered economist *John Maynard Keynes* has recognized this civilisatory chance. In his essay „Economic Possibilities for Our Grandchildren” (written 1930) he predicted that future generations would experience that the economic production problem will be solved. In about 100 years, thus around 2030, the standard of life would be 8 times higher with a remaining 15 hours work per week, he wrote. Then people could ascribe “economic life” the limited place it deserves and they could primarily dedicate their time to the more meaningful things of a cultivated life: *abundance of life* instead of mere abundance of goods could enrich human existence.

Unfortunately, jolly old Keynes was wrong with his prediction. He didn't foresee that the globalization of the markets would set back and complicate this project! We therefore need a fourth step against inherent necessities.

2.4 A Vital-political Market Framework of Global Competition Instead of “Competition of Market Frameworks“

The institutionally unrestricted competition between locations is always also a *competition between national regulatory frameworks*. According to the dominant logic of private capital investment, a framework is “good” if it is efficient for profit-making. This symptom of a political economism makes the current confusion between means and ends of the economy most evident: today there tends to be a competition between market frameworks instead of a supranational framework of global competition. Only such a supranational framework would be able to design and implement the *vital-political standards* necessary for sustainable development and for a competition that serves this development.

Put in a nutshell: *Who says A, must say B* – who is in favour of market globalization, should be reasonable enough to support a supranational framework for competition – and such a framework should not limit itself to a competition policy that is merely oriented towards efficiency as advocated by the WTO, but should extend to a *supranational vital policy!* This task is to be understood as an epochal challenge that certainly cannot be resolved politically in the short term. But we should acknowledge the principal reasonableness of Keynes' vision. Yet, as mentioned before, if we keep advocating the logic of economic growth as an inherent necessity we will never

achieve a civilized market economy that is embedded into sustainable ecological, social and cultural standards. Designing a civilized market economy is *the* epochal vital-political task that involves the community of all autonomous world citizens in the 21st century.

I don't see any alternative to such an endeavour of civilizing the market economy: in times of the global competition between national locations it is even more important to promote the transition of the global market economy from the paleoliberal "state of nature" in which the right of the stronger rules into a *cosmopolitan state of law*. In the very sense of Immanuel Kant's "Idea for a Universal History with a Cosmopolitan Purpose" (1784) the project of civilizing the global market economy merely can be solved within a *global governance*, not in a solo run by single countries. What we need most today is the courage to conduct supranational politics with a civilizing intent.

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PUBLIC SECTOR CREDIT RATING AGENCIES – A CONTRIBUTION TO A MORE STABLE GLOBAL FINANCIAL ARCHITECTURE

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ABSTRACT. The design of a more stable global financial architecture is currently the most important topic on the international agenda. But compared to the dimensions of the financial crisis, the solutions that have been put forward seem rather modest. While there is no doubt that more transparency as well as better designed and stronger capital buffers will help to make the global financial system more stable, it is far from clear whether such a piecemeal approach will help to prevent major crises in the future. The almost unlimited government support of banks in the current situation raises the stakes even higher and has increased the incentive problems facing bank depositors and lenders.

JEL: F01, F30, R53

1. Current Reform Proposals Are Not Radical Enough

The most radical reform that would be required to make the global financial system more stable is the establishment of effective international banking supervision instead of the extremely fragmented supervisory landscape we have at present. It is naïve to believe that national regulators will be able to regulate and supervise a highly integrated international financial system in an effective way. More coordination among national supervisors, especially in the form of supervisory colleges, and an early warning system under the auspices of the International Monetary Fund (IMF) are certainly helpful in this respect but they are an imperfect substitute for a global regulator.

While fundamental reform faces the almost insurmountably high hurdle of national interest, a radical solution is actually more realistic. When one tries to identify the main culprits of the current crisis, there is little doubt that the credit rating agencies have played a leading, if not the decisive role. Without their reckless rating-structured products the excessive growth of these assets would not

have been possible, and more generally the shift from a bank-based to a market-based financial system would have evolved in a much more gradual way. In the brave new world of market-based finance the rating agencies have played several important roles:

- First, they advised banks to design portfolios of low quality assets such that a large share of seemingly high quality assets would be created.
- Second, they rated their own creations, which made it possible for banks, pension funds and insurance companies to invest in such assets. In this way the rating agencies played the role of “delegated monitor” that – thus far – has served the needs only of the banks.
- Third, as not only private investors but also bank supervisors all over the world did not question the quality of the ratings, the agencies de facto served as privately-owned bank supervisors for the growing segment of asset-backed securities.

2. The Moral Hazard Problem of Private Rating Agencies

It is now widely agreed that the conflicts of interest which arise out of the dual role of consulting (in the process of structuring) and rating (the products created in such a process) need to be addressed. But the role of rating agencies as delegated monitor and de facto private supervisor of the universe of market-based finance has so far not been questioned.

This is surprising since the performance of the agencies has been far from satisfactory. In the past three decades no financial crisis has been anticipated by these institutions. Famous examples include the Asian crisis in 1997 (Ferri et al. 1998), the breakdown of Enron in 2002 and of course the current crisis. In the case of Lehman Brothers, up until 12 September, 2008 the ratings of this investment bank were beyond reproach and had not been changed for months (Standard&Poor's: A, Moody's: A2, Fitch Ratings: A+).

The dismal performance of rating agencies can be explained by their incentive structure. When the rating business began in 1909 with railway bonds, the agencies were paid by investors who needed information on the quality of the issuers (Partnoy 2006a). This changed in the second half of the 20th century when the rating agencies were paid by the issuers of securities. This result produced an incentive to be lax since more generous ratings increase the

volume of business. The incentive problem is magnified by the fact that the agencies do not assume any responsibility for their ratings. The agencies regard themselves as journalists and their ratings as “opinions” protected by the First Amendment of the US Constitution (freedom of speech). In other words, while the profits of overly generous ratings accrue to the agencies, the costs must be borne by investors or by governments when they have to bail-out the issuers. This is the typical structure of a moral hazard problem: an agent incurs excessive risks since he is protected against losses by another institution.

It has been argued that effects of this asymmetric incentive structure are constrained by the negative effects of inadequate ratings on the reputation of the agencies (Covitz and Harrison 2003). But this argument overlooks the fact that due to the oligopolistic market structure there is no effective competition between the three major rating agencies. Given repeated failures in the rating process, market forces should have had the effect of driving at least one agency out of business. However, while many banks and other financial institutions have become insolvent or have had to be nationalized in the past 18 months, all three rating agencies have survived the storms of the financial crisis remarkably well. In other words, the market process has not been able to sanction the rating agencies for their overly positive assessment of highly dubious assets.

If one takes into account the important role attributed to external ratings in the regulations of Basel II, it seems very questionable that a more stable financial architecture can be achieved as long as rating agencies remain in private hands. While it will be possible to improve the performance by a better code of conduct (CRA Code of Conduct 2008 by the International Organization of Securities Commissions¹) and a public regulation of rating agencies, it seems almost impossible to overcome the fundamental problem of an asymmetric incentive structure of private rating agencies that operate in an oligopolistic environment without any liability for their ratings.

3. Hayek and the Rationale of Public Rating Agencies

The obvious alternative is a state-owned credit rating agency. Without a profit motive the incentives would no longer be biased. Of course, if ratings are given by a public institution the governments would be responsible for mistakes in the rating process. But as the

current crisis shows, governments are already now obliged to bail-out banks that have relied on the ratings of private institutions. Ratings by public institutions would thus be consistent with the principle of competence and liability. The shift from private to public agencies could induce a relatively conservative rating culture but given the huge social costs of imprudent ratings by private agencies such a conservative bias is exactly the element of stability that is required for a more robust financial architecture.

The case for public credit rating agencies can also be made by referring to Friedrich A. Hayek's fundamental justification of the market mechanism. In his famous *American Economic Review* article,² he writes:

If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. We cannot expect that this problem will be solved by first communicating all this knowledge to a central board which, after integrating all knowledge, issues its orders. We must solve it by some form of decentralization.

Thus for Hayek, the rationale for the market and private agents rests fundamentally on their advantages in terms of gathering and processing decentralized pieces of information. But this justification does not apply to rating agencies. A global financial system with only three major agencies comes very close to Hayek's model of central planning:

The statistics which such a central authority would have to use would have to be arrived at precisely by abstracting from minor differences between the things, by lumping together, as resources of one kind, items which differ as regards location, quality, and other particulars, in a way which may be very significant for the specific decision. It follows from this that central planning based on statistical information by its nature cannot take direct account of these circumstances of time and place.

In other words, there is no reason to assume that the three major private rating agencies have any advantage over a state-owned agency in terms of collecting and processing information. Thus, given the biased incentive structure of private agencies, the global financial architecture would become more stable with public credit rating agencies.

4. A European Initiative Would Be Already Sufficient

As two US agencies (Standard&Poors and Moody's) play a pre-dominant role³, it is not very likely that the United States would support the case for public credit rating agencies. But in contrast to other reforms this approach does not require an international backing. It would be sufficient that the European Union member states decide to set up a public European credit agency. The establishment of another major agency would increase the global competition between rating agencies. In addition a public rating agency with a more conservative approach would have the effect that the competing private institutions have to adopt more rigorous standards. For the member countries of the EU such a public rating agency would have the additional advantage that its ratings could be used as a benchmark for bank supervisors for all banks within the EU. If the public agency does a better job than the private agencies, it would drive them out of business over time (Beetsma 2008). Thus it is not necessary to nationalize the existing agencies.

It is often said that every crisis brings a chance for things to be done better. This also applies to the financial market crisis which has now opened a window of opportunity to establish better regulations and institutions for the global financial system. While most of the proposals discussed so far are very useful they lack the willingness to achieve fundamental reforms. As external ratings are of decisive importance for the universe of market-based finance, public rating agencies would overcome the very incentive problems of private agencies which should now be regarded as a main cause of the current turmoil. If this opportunity is not taken now, the international community will have to wait for the next crisis.

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3. Fitch is owned by Fimalac a French company.

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IS THERE A PH.D. GLUT IN ECONOMICS IN ACADEMIA?

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ABSTRACT. The academic market for Ph.D. economists in academia works like any other semi heavily regulated market with a large element of government ownership and with large time lags in supply: there are shortages and surpluses, but these tend to be self correcting, with enough time allowed for adjustments. Contrary to the claims of some, there is no such thing as a chronic glut.

JEL: A11, J23, J44, J63, J64

No one can deny that the supply of new Ph.D. economists can only match the demand for it, in fits and starts, and, at best, only roughly, or approximately. Without perfect information, there simply must always be either a shortage or surplus of this subset of the labor supply. This market, like that for any other good or service, cannot be continually in equilibrium. So, from time to time, there will be “gluts,” excessive supplies of would-be professors, or shortages, too few of them offering their services to man all of the classrooms for which there is a need for them.

And, indeed, the facts bear this out. For example, according to Boddy (1973, 720):

It is to be noted that the expansion of enrollments, both first year and total, for advanced degrees was a lower rates during the last four years... than for the decade as a whole and that this pattern was clearer and stronger for economics and for agricultural economics than for all fields.

Expansion of the number of advanced degrees in agricultural economics shows the same general pattern: substantially lower growth rates for the last four years than the decade. In economics ... the output of Ph.D.s in the last four years increased more rapidly than for the decade as a whole.

Further, in the view of Hoffman and Low (1983, 480):

Economists typically assume that the world is relatively free of informational barriers and that agents carefully process vast amounts of information in making decisions. This study reveals whether economists' own occupational decisions are consistent with this world of rational calculating agents. Results suggest that tests for the internal consistency of rational expectations and our model of occupational choice cannot be rejected...

However, it is *equally* undeniable that there is a continual market process¹ at work in this labor market, as there is in all other markets. That is, when there is a shortage of warm bodies to place in the seats in front of university students, *ceteris paribus*, there is a subsequent increase in the number of first year Ph.D. candidates. And, when there is a surplus of professors, the new entrants into graduate school decreases.²

True, this market does not work as seamlessly and flawlessly, as some others. Why not? There are several reasons. For one thing, the overwhelming majority of firms in the academic industry are either partially or entirely state owned, or heavily subsidized by the government. Wages and salaries, therefore, are not as flexible as they otherwise would be, and are, in other industries experiencing labor mismatches with job openings.

For another, there is a relatively large time lag between the time a shortage develops, and when new supply can come pouring into the market to alleviate it. The Ph.D. degree in economics is a credential virtually all candidates for professorships in this field must possess,³ and this takes from 4-7 years to acquire (Stock and Siegfried. 2006).

North (2006) does not agree. In his view: "The Ph.D. glut has existed ever since the fall of 1969. The number of entry-level full-time professorial positions has remained stagnant." If this is to be taken literally, and, how else are we to interpret it, it means that there has been a *continuous* oversupply of professors for more than three and one half decades, with no interruption in it whatsoever. If so, someone should immediately contact Ripley's believe it or not, for a world's record of some sort has been established.⁴ And, what is this author's explanation for so unusual an occurrence? He (2006) argues as follows:

Why does a glut exist? Because of an error in prior forecasting. Suppliers believed that there would be buyers at a specific price. It turned out that there was (sic) an insufficient number of buyers at that expected price.

Then why does a glut persist? One answer: ignorance on the part of suppliers. But why should this ignorance persist? Why don't suppliers get the picture?

Experienced sellers *do* get the picture. The problem is a continuing supply of new sellers who are unfamiliar with the market and ignorant of the past supply-demand conditions. Or, as has been said so often, there's a sucker born every minute...

In the worldwide suckers' market, gamblers are the only people who are slower to learn than young adults with masters' degrees. Bright graduate students possess a pair of non-marketable skills: the ability to write term papers and the ability to take academic exams. They are also economic illiterates and incurably naïve. So, they become the trusting victims of the professorial class.

North's view is supported by Smith (1776) who states:⁵

That unprosperous race of men commonly called men of letters, are pretty much in the situation which lawyers and physicians probably would be in upon the foregoing supposition. In every part of Europe the greater part of them have been educated for the church, but have been hindered by different reasons from entering into holy orders. They have generally, therefore, been educated at the public expence, and their numbers are every-where so great as commonly to reduce the price of their labour to a very paultry recompence.

Block (2008) rejects this on the ground that "this sounds like people with a doctorate in poetry, or feminist studies, but seems to ill fit those who have just completed a half decade of study of the dismal science." But this does not go far enough. If enough "new sellers" who are graduates of programs in liberal arts end up driving taxi cabs, or dispensing coffee, or asking if "you want fries with that," then even such economic illiterates will eventually figure out that investments in human capital will earn greater rewards in other fields. They will notify their younger siblings about their findings. Enterprising journalists will write about it. Guidance counselors will

advise on the basis of it. The next generation of would-be poets and students of feminism will eventually be dissuaded from these fields. If not, the unemployment in these fields will reach Herculean proportions, which has never occurred.

Another author who complains of an academic glut is Vanderkam (2003) who avers:

The year after Ellen Paul earned her Ph.D. in European history from the University of Kansas, she drove a school bus to make ends meet.

Roughly 45,000 new Ph.D.s will be graduating this year, double the number from 35 years ago. Almost all believe they will turn their long, underpaid pursuit of truth into professorships – the tenured kind in which they can't be fired and can research what they spent five or more years studying. But universities, despite dangling tenured professorships like carrots to their graduate students, haven't doubled their tenure-track hiring. So, particularly in the humanities, new graduates such as Paul who want to stay in academia face years of part-time, benefitless "adjunct" positions in which they try to teach and research despite having no job security and working other jobs to pay the rent.

The world has worse tragedies than Ph.D.s driving buses. Still, this mismatch between professorships available and Ph.D.s granted is a colossal waste of brainpower sorely needed elsewhere. Universities that glut the doctorate market bear much responsibility for the situation. But graduate students aren't blameless.

These men and women have chosen to spend years training for jobs that don't exist by accruing knowledge no one will pay for. The most devoted to their passion may decide that's all right. But the 'starving Ph.D.' phenomenon is here to stay. Even the ivory tower can't save anyone from that reality.

Today's market mismatch began in the 1960s, when baby boomers poured into colleges, and administrators went on a hiring spree.

Wright (2002) also offers a tale of woe about the unemployment of academic historians.⁶ For one thing, it concerns non economists, who may be expected to be less sophisticated about matters of this sort.⁷ Says Boddy (1973, 724) in this regard:⁸ "... the scare talk about the current and prospective general 'Ph.D. glut' is greatly overdrawn ...

In economics and agricultural economics the prospects are far less discouraging than in most other fields.”⁹ More important, the claim here is that the glut is a *permanent* phenomenon, not something that comes and goes. Even economic illiterates will eventually catch on to the fact, if it is indeed a fact, that there is an oversupply of people with their backgrounds in academia. Then, perhaps, there will be an over reaction, and too few will obtain Ph.D.s in these fields in the next age cohort. If so, this industry, like any other, will experience over and under supply, varying with each other, always approaching an equilibrium situation, but never quite attaining it, except, perhaps, very temporarily.¹⁰

Then, too, there is the problem that academia is not market oriented (Klein and Chiang, 2005), as a general rule. Instead of allowing supply and demand to determine the salaries of professors, leftist administrators have imposed their own views of what is fair on this segment of the labor market. To wit, the practitioners of some disciplines (e.g., poetry, sociology, history, feminist and black “studies”) have far fewer and less remunerative alternatives in the “real” world than do those in others (e.g., economics, finance, chemistry, computer science, law). *Ceteris paribus*, this would imply higher salaries in the latter than the former. Says Wright (2002) in this context: “While the average salary for new tenure-track assistant professors in history, around \$40,000 per year, is modest given the demanding nature of the job and the many years of training it requires, the salary is, in fact, higher than necessary to attract qualified applicants.” Yet, to the socialist administrator it is patently unfair that an expert in Adam Smith earn more than someone with knowledge of Shakespeare or Malcolm X. Thus, pay in the latter is artificially raised, while that in the former, at least relatively, is lowered. But as a perusal of economics 101 will demonstrate, this implies comparatively more unemployment in the humanities.

Let us return to Gary North, Ph.D., since he is perhaps the sharpest critic¹¹ of the idea that a Ph.D. in economics can often make sense from a human capital, or, indeed, any other perspective. In North (2008b) he makes three main points. In the first section of his paper, he reiterates the claim that it would be unwise, in the extreme, for anyone to attempt to enter in to the professoriate, and likens such folly to encouraging black teens to undertake a career in professional sports:

If you make it into the NBA, you will make a lot of money. The salaries are great. Hardly anyone gets signed. Most are journeymen. When you think ‘college professor,’ think ‘NBA.’ Then think ‘never survived the cut.’ We tell ghetto youths not to dream of making it into the NBA. We don’t warn undergraduates of the same unrealistic dream of making it onto a college faculty.

However,¹² there are 30 teams in the NBA,¹³ each with a roster of 12 members. That brings us to a grand total of 360 employment slots. There are some 3,000 four year colleges and universities in the U.S., that together employ tens of thousands of professors. The differential between these two numbers is so gargantuan that this divergence appears, almost, as a difference in kind, not degree.¹⁴

North (2008b) is undoubtedly correct to point out the importance of publishing in refereed journals in order to obtain tenure, and, also, the bias against Austrian economists in this regard.¹⁵ But, surely, this statement is a wild exaggeration: “Almost no article ever published in a peer-reviewed professional economics journal has been written by an Austrian School economist.”¹⁶ This is so preposterous a claim that it is not even worth offering evidence to the contrary.¹⁷ The next difficulty with North (2008b) is this claim:

Professor Block, a now-tenured professor who spent years outside any university, due to hostility to his Austrian School views, has offered a rebuttal. He think (sic) salaries are high in the field of economics.

This is true – if you get tenure. If you don’t get tenure – and very few do – then you are tossed out of the university-level teaching slots ... and relegated to part-time teaching at below-plumber hourly rates in a community college.

North is referring to Block (2008), wherein the following appears: “Well, let’s see. According to *this source*, the average salary for a community college faculty member ... nationally ... was \$53,934. Round this up to \$54,000. ... Assume that the professor teaches 5 courses of 3 hours each for 30 weeks a year (yes, these people get long vacations too). That amounts to 450 hours per year (we ignore publishing requirements, committee meetings, marking essays, since there are virtually none in this sector of academia), or \$120 per hour,

roughly 10 times North's estimate of '\$10 to \$15 an hour.' I wonder at the source of his calculations.

North (2008b) vouchsafes us no response to Block's (2008) claim that North's (2008a) claim of '\$10 to \$15 an hour' was a gigantic underestimate. Worse, he repeats the error, now conflating community college instructors' wages with those of "plumbers."¹⁸

The second section of North (2008b) offers advice to people in their 50s who have been stricken with the economics bug. He suggests that they refrain from the graduate school route, and attempt to learn this material on their own, without benefit of the Ph.D. credential. This counsel is not unwise from a strictly dollars and sense perspective, given the shorter life expectancy, and thus the fewer number of years such people will have to recoup these costs. But in his section three North (2008b) again gives the back of his hand to the idea that a young person "should ... jump through the (academic) hoops for five years?" He continues: "The number of professors in American universities who have tenure and who are Austrian School economists may be as many as 20. I cannot actually name these people, but there may be this many. That is the total out of over 4,000 colleges in the United States."

Again, we have an underestimate of gigantic proportions.¹⁹ There are more than twenty, many more, Austrian economists who have tenure at the present time at American universities. What is the precise number? This is difficult to determine. There are several margins to consider. First, what, precisely, is an Austrian economist?²⁰ How "Austrian" must one be to be counted as such? We do not want to include anyone who once mentioned praxeology or market process in a positive way. On the other hand we do not want to be arbitrarily exclusionary. In the appendix to this paper we list the Austrian economists known to us under a three part categorization. A: those who are Austrians without a doubt, who serve as the core contributors to this economic philosophy. B: those who have made lesser but still significant contributions to this discipline; e.g., they have authored a book on the topic, or at least a few refereed journal articles promoting this discipline; C: those for whom there is a significant question as to their Austrian credentials; they have an interest in this perspective, but cannot be counted as Austrians. "Fellow travelers" might be the best characterization of them. Second, why consider tenure awarded to Austrians only at American universities? Surely, the fact that a foreign institution of higher learning

singled out a member of the praxeological school for this honor is not irrelevant to the effect that Austrianism has on the academic community. Foreign scholars, as well as those based in the U.S., contribute to our body of economic knowledge. However, since North (2008b) mentions “American universities” we mention Austrians awarded tenure by foreign universities in a separate category. Third, what about Austrians awarded tenure who have voluntarily given it up, and thus no longer “have” it? We include them, on the ground that they succeeded in the academic game, but then rejected their success, presumably, in favor of something they valued even more. Fourth, just for completeness, we mention Austrian scholars who have received tenure in the past, but who are now deceased. We do not count them in the number to be contrasted to North’s (2008b) “as many as 20.” Fifth, what about an American university that does not offer tenure to *any* of its faculty members; we include Austrians who have been employed there for more than seven years, on the ground that tenure indicates permanency of position, and this would appear to qualify. Sixth, what about those with Ph.D.s in other fields (e.g., philosophy, finance, history) who may be working in either economics departments, or in their own fields, but who have made signal contributions to the Austrian edifice? We have included them, in the B category. They may not have Austrian credentials, but they are indeed, in our view, Austrian economists. Seventh, how do you count scholars tenured in other countries who gave up their faculty posts there to move to untenured positions in the U.S.? We have ignored this possibility.²¹

So, how many tenured Austrian economists “are” there? Well, it depends upon the definition employed. Based on calculations in the appendix, we arrive at this tentative conclusion:

	cumulative
A: 75	75
B: 36	111
Foreign: 42	153
Deceased: 34	187
C: 18	205

We may say for sure²² that there are at least 111, counting the A’s and the B’s. If we include non Americans, and surely, they do contribute, mightily, to the world wide renaissance of Austrian economics, we arrive at 152. Including the deceased, the number rises to

186, and if Austrian fellow travelers with tenure are added, then 204. But no matter which of these numbers is the most correct, all of them far exceed North's insulting estimate of 20.

In concluding the third section of his paper, North (2008b) is quite right to wax indignant at the shabby treatment according the leading lights of Austrian economics by American universities, people like Ludwig von Mises, F.A. Hayek, Murray N. Rothbard, and Henry Hazlitt. But this demonstrates, even the more, the remarkable perspicacity of those Austrians who have persevered in academia, and achieved tenure status, North's advice to them to the contrary notwithstanding.²³

It is time to conclude the present paper. Yes, there always have been, are now, and likely will be in the future, gluts, or excessive supplies of labor in academia. There have also been, are now, and will be, again, shortages. This is part and parcel of the free enterprise system. The market works less well in the sector of the economy, due to excessive government intervention. But, shortages and surpluses will undoubtedly continue to succeed one other, here, too, as they do in relatively freer parts of the economy.

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NOTES

1. See on this, Boettke, and Prychitko, 1998; Cowen and Parker, 1997; Ebeling, 1985, 1990; Ekelund and Sauman, 1988; Foss and Mahnke, 2000; Foss and Christensen, 2001; Gordon, 1995; Kirzner, 1982, 1992; Lachmann, 1976, 1977; Langlois, 2001; Robertson and Yu, 2001; Thornton, 1994; Wagner, 1989; Yeager, 1986.

2. Cawley (2006, tables 2 and 3) reports that both the number of candidates and job openings for economists in academia have not been oscillating wildly in the last few years. Economics Ph.D.s Granted by U.S. Universities: 2000: 948; 2001: 930; 2002: 903; 2003: 932; 2004: 960. And the number of academic jobs offered during these same years are: 2000: 1,635; 2001: 1,589; 2002: 1,487; 2003: 1,381; 2004: 1,487; 2005: 1,715.

3. Exceptions include David Friedman, with a Ph.D. in physics, Jeff Hummel with a Ph.D. in history and Gordon Tullock, Henry Manne, Ludwig von Mises and Friedrich Hayek with degrees from law schools.

4. A priori history is always and ever illegitimate; it is solely an empirical issue as to whether at any time there is a shortage or surplus of economics (or other) professors. Only valid, technically correct, empirical work can adequately address this issue. For example, see Boddy, 1973; Freeman and Breneman, 1974, Scott, 1979; Hoffman and Low, 1983; Schrimper, 1981.

5. I owe this cite to Morris Coats [mailto:Morris.Coats@nicholls.edu]

6. See also Baker, 1994, on this complaint.

7. As well, economists have many more options in the world of business, think tanks, government, than do humanities students.

8. Cited in Schrimper, 1981, 748.

9. Wright (2002) supports the view that employment prospects are better for economists than historians.

10. Of course, it is entirely possible, once psychic income is taken into account, for there to be a chronic “oversupply.” Scare quotes around the last word in the last sentence, since under these conditions there would not be an “oversupply” at all. Under this assumption, poets, historians, sociologists, so much enjoy pursuing Ph.D.s in these subjects that would do so, and continue to do so, whether or not employment in academia awaits them.

11. See North, 2000, 2006 and 2008a. For a rejoinder, see Block, 2008.

12. A ghetto is properly defined as an area wherein a despised minority is *compelled* to live. Strictly speaking, there are no “ghettos” in the U.S. at the present time.

13. http://sports.yahoo.com/nba/teams;_ylt=An5jJ.A63s3BE4Pr.fA6pue8vLYF

14. If it is objected that there are also development leagues for basketball, and a woman’s league, the WNBA, the response is that there are also a significant number of community colleges.

15. Rosen (1997), Vedder and Gallaway (2000) and Laband and Tollison (2000) deny this charge; see rejoinders by Anderson (2000), Block (2000), Thornton, 2004; Yeager (1997, 2000). See also Klein and Chiang, 2005, Backhouse, 2000.

16. Most egregious is North’s (2008b) claim that “Murray Rothbard abandoned the attempt (to publish in a peer-reviewed professional economics journal) no later than 1961.” Even a superficial perusal of his c.v. will show that he published numerous articles in the *Review of Austrian Economics*, the *Journal of Libertarian Studies* and in the *Quarterly Review of Austrian Economics*, all of them “peer-reviewed professional economics journals.”

17. Were we to list merely the titles of all the articles published in refereed journals by Austrians, it would take more space than this entire article. See appendix below for just a hint of this.

18. Well, maybe, to give him a sympathetic reading, the plumbers North is accustomed to dealing with are paid \$120 per hour.

19. It seems a bit churlish on North's part to complain of the paucity of Austrian economists with tenure, after he has done all in his power to dissuade them from attaining this goal.

20. This appellation has nothing to do with the economic situation in the country Austria. Rather, it depicts a praxeological, as opposed to an empirical, methodology. It is named this way because all of its early practitioners, Carl Menger, Eugen Bohm-Bawerk, Ludwig von Mises and Friedrich Hayek pre eminent amongst them, were born in that country, and practiced there early in their careers. See Rockwell (1995) on this.

21. It would be nice to be able to track this information on a 5 or 10 year basis (a suggestion made to me by William N. Butos), so that growth rates would be available. Unfortunately, so ambitious a calculation is far beyond the scope of the present paper.

22. This number may either be an overestimate, in that it is possible that some of these people really do not have (not had) tenure, or an underestimate, if some of those who should be on this list have evaded detection.

23. North's publications on this subject (2000, 2006, 2008a, 2008b) have all been in venues read by a disproportionate number of Austrians. To the extent his advice is taken up by his readers, this would tend to diminish the number of Austrian professors. If North is really intent upon promoting praxeological insights, one wonders why he does not try to convince non Austrians of the folly of entering the professoriate?

24. He is an Austrian, at least on cost, which is important, but, he is also a self-hater: he thinks that Austrianism is a cult, so he can't really be one in good standing, despite his contributions to it.

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Appendix

This is a letter sent out by the authors in June 2008 so as to generate a listing of Austrian economists:

Dear Colleagues:

I am attempting to determine how many Austrian economists (self-claimed, self-styled or self-defined) are there in the world, living or dead, who have tenure or, who have ever had tenure at a college or university. I include Herbener and Rittenour, even though they don't have tenure (their jobs are contractually very secure) and also Roderick Long, Paul Cantor, and several others (even though their phd is not in economics, and they work in departments other than economic, since they have published Austrian articles in refereed journals). I'm trying to make this list as large as possible, by including all questionable people. I full well realize there is a gradation between “pure” Austrians, and fellow travelers, or Austro sympathizers. Note, that I'm counting Leland Yeager and James Buchanan (very much an Austrian on cost and subjectivism) so please use them as a touchstone; anyone at least as Austrian as they should be included. Note, I'm also including people such as George Selgin, Tyler Cowen and Bryan Caplan, since all have tenure, and were Austrians at least at one time. I also include people who once had tenure at a given university, but voluntarily gave it up. Bob Higgs, for example, was once awarded tenure by Lafayette University, but left that position. Also, please help me identify the universities which once awarded tenure to Austrians where this information is missing from my list.

On the other hand, if there's someone on my list who never got tenure anywhere, at any time, and clearly is not an Austrian even under my inclusive definition, please let me know. I don't want to include anyone who has ever used the word "praxeology" in a publication, or cited Menger, Bohn-Bawerk, Mises, Hayek or Rothbard.

I have erred, in all likelihood, in the direction of over inclusiveness; I did so on the ground that it is easier to eliminate mistaken names, than to add those I have excluded in error. PLEASE help me make this as accurate as possible.

The reason I am putting together this list is to refute this piece: North, Gary. 2008. "Why the Ph.D. Glut Is Not Going Away, and Why Austrian School Grad Students in Economics Should Go into Business Instead." July 1; <http://www.garynorth.com/public/3700.cfm>

My good friend Gary is on the warpath against those of us, including me, who are trying to steer young people who like and appreciate Austrian economics into the professoriate. Gary thinks we are misleading these young people. He claims that only 20 Austrians have tenure in the U.S. He states: "The number of professors in American universities who have tenure and who are Austrian School economists may be as many as 20. I cannot actually name these people, but there may be this many. That is the total out of over 4,000 colleges in the United States."

In my refutation of Gary, I want to be fair. There are of course gray areas in including people on a list of Austrians with tenure. I am including Austrians with no tenure, if the school that are at does not give tenure to anyone, but they have been there for more than seven years. I am including Austrians who *had* tenure, but gave it up for untenured positions they regarded as preferable (Higgs, Ebeling and Thornton are included, and listed at the places that awarded them tenure, even though they are no longer still there). I am including people in other fields (e.g., Roderick Long in philosophy) as long as they have tenure and make contributions to Austrian economics. I am even including people who were once Austrians, and got tenure as Austrians, even if they have changed their minds on this matter. But, I must make a *strong* distinction between Austrians, on the one hand, and mere free enterprise economists on the other, who are not Austrians. I am willing to operationally define an Austrian economist as a free market advocate who has had at least one publication in an explicitly Austrian journal, or at least one publication where he explicitly supports at least a few aspects of this school of thought – unless I know that scholar personally, and have good reason to reject him for inclusion. For example, I'm not including James Buchanan. He has tenure, and his work on cost is surely Austrian; but I once heard him say that he considers Austrianism a cult.

I include a number of people who have been proposed to me as candidates for this list, who I have so far not included. If you know any thing about their tenure status, and/or Austrian credentials, please let me know.

My primary purpose is accuracy. I don't really care if people want to be included on this list or not. If they belong there, I want to include them, whether they like it or not. On the other hand, if this would cause personal problems for anyone, I'll make exceptions. As you can see, I already have WAY more than 20 people on the list.

I have heard it said that someone was not really an Austrian, because he did a lot of empirical research. In my view, doing empirical research does not at ALL preclude you from being an Austrian in good standing. There are two kinds of empirical research in my view. I. studies that deal with apodictic issues; such as, is free trade mutually beneficial in the ex ante sense, does the minimum wage law unemploy people with MRPs below the level stipulated by law; II. studies that do not deal with apodictic issues, such as, what is the elasticity of demand for bananas. No research, whatsoever, of type II can preclude anyone from being an Austrian, in my opinion. As for type I, if you interpret your research as *testing* praxeological truths, then, and to that extent, you are not an Austrian. On the other hand, if you interpret it as merely *illustrating* economic law, then you are acting completely compatible with Austrianism.

People whose names are ~~crossed out~~ were mentioned to me as possible Austrian candidates, but either do not have tenure, or, do not even deserve a C ranking in my opinion. Please use word search for the question mark (?). I really need help here.

Appendix

Bill Anderson, Frostburg State (A); William P. Anderson, Grove City College (B); Dom Armentano, University of Hartford (A); Roger Arnold, Cal State San Marcos (B); Howard Baetjer, Towson University (A); Chuck Baird, Cal State, Northridge (A); William Barnett II, Loyola University New Orleans (A); Robert Batemarco, Marymount College (A); Don Bellante, University of South Florida (A); Bruce Benson, Florida State U, Tallahassee (A); Walter Block Loyola University New Orleans (A); Peter Boettke, GMU (A); Cecil Bohanan, Ball State University (B); Sam Bostaph, University of Dallas (A); Don Boudrouex, GMU (A); William Breit, Trinity University, Texas (A); Barry Brownstein, University of Baltimore (B); James Buchanan, GMU (C)²⁴; Bill Butos, Trinity College, Connecticut (A); Bruce Caldwell, U. of North Carolina-Greensboro, Duke (C); Peter Calcagno, College of Charleston (A); Steven T. Call, Metropolitan State College of Denver (A); Bryan Caplan, GMU (C); Tony Carilli, Hampden Sydney (A); Art Carol, Baruch College (A); Paul Cantor, University of Virginia (B); Brian Caplan GMU (C); Emily Chamlee-Wright, Beloit University (B); John Cochran Metropolitan State College, Denver (A); Tyler Cowen, GMU (C); Steve Cunningham University of Connecticut (C); Paul Cwik, Mount Olive College (B); Greg Dempster Hampden Sydney (A); Tom DiLorenzo, Loyola College

in Maryland (A); William Easterly NYU (C); Richard Ebeling, Hillsdale College (A); John Egger, Towson University (A); Fred Foldvary, Santa Clara University (B); Gary Galles, Pepperdine University (B); Roger Garrison, Auburn University (A); Fred Glahe, University of Colorado (A); Stephan F. Gohmann, University of Louisville (C); Gerald Gunderson, Trinity University Connecticut (A); Steve Hanke, Johns Hopkins (C); David Harper, NYU (A); Klaus Hennings (B); Jeff Herbener, Grove City College (A); Bob Higgs, Lafayette College, University of Washington (A); Jack High, GMU (A); Randy Holcombe, Florida State University, Tallahassee (A); Hans Hoppe, UNLV (A); Steve Horwitz, St. Lawrence University (A); Jeff Hummel, California State University, San Jose (C); Sanford Ikeda, SUNY, Purchase College (A); Edward Kaplan, Western Washington University (A); Samson Kimyeni University of Connecticut (C); Jerry Kirkpatrick, California Polytechnic (B); Israel Kirzner, NYU (A); Roger Koppl, Fairleigh Dickinson University (A); Dan Klein, GMU (A); Peter Klein, University of Missouri (A); Audrey (Davidson) Kline, Louisville University (C); Richard N. Langlois University of Connecticut (A); Bob Lawson, Capital University, Auburn (C); Peter Lewin, University of Texas, at Dallas (A); Roderick Long, Auburn (B); William Luckey, Christendom College (A); Frank Machovec, Wofford College (A); Yuri Maltsev, Carthage College (A); Donald Mathews, College of Coastal Georgia (B); Margaret Maxey, University of Texas, Austin (B); Bob McGee, Seton Hall University (A); Ronald McKinnon, Stanford (C); Michael Montgomery, University of Maine, Orono (A); Larry Moss, Babson College (A); Robert Mulligan Western Carolina (A) David O'Mahoney, Cork University (B); E. C. Pasour, North Carolina State University (B); Ivan Pongracic, Jr. Hillsdale College (A); Ivan Pongracic, Sr. Indiana Wesleyan University (A); Dave Prychitko U. of Northern Michigan (A); Ralph Raico, Buffalo State College (B); Salim Rashid, University of Illinois (B); George Reisman, Pepperdine University (A); Morgan Reynolds, Texas A&M (B); Shawn Ritenour, Grove City College (A); Mario Rizzo, NYU (A); Murray Sabrin, Ramapo College (A); Fr. James Sadowsky, S.J., Fordham University (B); Joe Salerno, Pace University (A); Mike Saliba, Loyola University New Orleans (B); Larry Sechrest, Sul Ross University (A); George Selgin, University of Georgia (B); Butler D. Shaffer, Southwestern University School of Law (B); Milton Shapiro, Claremont Graduate School (B); Jeremy Shearmur, Australian National University (A); Andrei Shleifer, Harvard (C); Gene Smiley, Marquette University (B); Barry Smith, State University of New York, Buffalo (B); Vernon Smith, Chapman College (B); Thomas Sowell, UCLA (C); Louis Spadaro, Fordham University (A); Ed Stringham, California State University, San Jose (A); Daniel Sutter, University of Texas-Pan American (C); Alex Tabarrok, GMU (A); Thomas Taylor, Wake Forest University (A); Tim Terrell, Wofford College (A); Mark Thornton, Columbus University (A); Hunt Tooley, Austin College (B); David Tuerck, Suffolk University (B); Victor Vanberg GMU (A); T. Norman Van Cott, Ball State University (B); Karen Vaughn, GMU (A);

Richard Vedder, Ohio University (B); Harry Veryser, University of Detroit, Mercy (A); Richard Wagner, GMU (A); Doug Walker, Georgia College and State University, College of Charleston (B); Deborah Walker, Loyola University New Orleans (A); Allan Walstad, University of Pittsburgh (B); Joseph Weglarz, University of Detroit, Mercy (A); Chris Westely Jacksonville State (A); Larry White, University of Missouri-St. Louis (A); Stuart Wood, Loyola University-New Orleans (A); Thomas Woods, Suffolk County Community College (A); Bill Woolsey, The Citadel (B); Mark Yanochik, Georgia Southern (B); Leland Yeager, Auburn (C); Bong Joon Yoon, State University of New York; Binghamton (B); Ed Younkins, Wheeling Jesuit University (A).

Deceased Austrians with tenure:

Benjamin M. Anderson, UCLA; Eugen von Bohm Bawerk ; Wein Claudi; Gottfried Haberler, Harvard; Friedrich Hayek, University of Chicago; Paul Heyne, University of Washington; William H. Hutt; Emil Kauder; Ludwig Lachmann, University of Witwatersrand; Don Lavoie, GMU; Bruno Leoni; F.A. Lutz; Vera (Smith) Lutz; Fritz Machlup, Princeton; Carl Menger; Hans Mayer; T.F. McManus; Oskar Morgenstern, NYU; Vernon Mundt; R.W. Nelson; C.A. Phillips; Gerard Radnitzky, University of Trier; Lionel Robbins, London School of Economics; George Roche III, Hillside College; Wilhelm Roepke; Paul Rosenstein Rodan, MIT; Murray Rothbard, UNLV; Joseph Schumpeter, Harvard; Hans F. Sennholz, Grove City College; Sudha Shenoy, University of Newcastle; William Smart; Eric Streissler; Richard von Strigl; Friedrich von Weiser.

Foreign (non U.S.) Austrians with tenure:

Dario Antiseri, LUISS Guido Carli, Rome; Marco Bassani, University of Milan; Gerard Bramouille, France; Juan Carlos Cachanosky; Roberto Cachanosky; Gabriel Calzada, Universidad Rey Juan Carlos; Jean-Pierre Centi, Universite Paul Cezanne, Aix en Provence, France; Enrico Colombatto, Università di Torino; Eric Crampton, University of Canterbury, Australia; Raimondo Cubeddu, University of Pisa; Pierre Desrochers, University of Toronto; Nicolai Foss, Copenhagen Business School; Pierre Garello, Universite Paul Cezanne, Aix en Provence, France; Jacques Garello, Universite Paul Cezanne, Aix en Provence, France; Pierre Garrouste, University of Lyon, France; Antoine Gentier, France; Ron Hamowy, University of Alberta, Canada; Guido Hulsmann, University of Angers, France; Lorenzo Infantino, LUISS Guido Carli, Rome; Ubiratan Iório, Rio de Janeiro State University; Martín Krause, ESEADE; Elizabeth Krecke, University of Law, Economics and Science of Aix-Marseille; Peter Kurrild-Klitgaard, University of Southern Denmark; Gustavo Lazzari; Helmut Leipold, University of Marburg;

Christopher Lingle, University of Natal, Durban, South Africa; Steven Littlechild, University of Birmingham; England; Alberto Benegas Lynch; Herve Magnouloux; Naomi Moldofsky, University of Melbourne, Australia; Antony Mueller, Universidade Federal de Santa Catarina; Philippe Nataf, Paris France; Jean-Yves Naudet, Universite Paul Cezanne, Aix-en-Provence, France; Peter Oberender, University of Bayreuth, Germany; Adrián Ravier; Duncan Reekie, University of Witwatersrand; Pascal Salin, University of Paris; Alfred Schüller, University of Marburg; Josef Sima, Prague University of Economics; Jesus Huerta de Soto, Universidad Rey Juan Carlos; Stefan Voigt, University of Marburg; Tony Yu, University of New South Wales; several Austrian economists at University Francisco Marroquin.

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THE RISK ASSESSMENT PRACTICES OF AUDIT FIRMS

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ABSTRACT. Abdullatif and Al-Khadash hold that the international audit firms generally apply a set of international quality control criteria to be applied in every individual country in which they operate. Mariani et al. write that firms with the largest absolute value of total accruals will show higher discretionary accruals. Blay et al. address the question of whether the aggregation of inherent and control risks into one measure (misstatement risk) impedes auditor decision-making. Bedard et al. use auditors' evaluations of their clients' systems risk factors as a source of data on the difficulties frequently seen in company systems.

JEL: G32, M41, M42

1. Introduction

Abdullatif and Al-Khadash analyze views of Jordanian auditors about how the business risk audit approach is applied in practice by Jordanian audit firms and how appropriate and practical the application of such an international approach to auditing is in a different context from that where it was established. International audit firms promote the application of an international audit approach covering procedures for audit planning, risk assessment and substantive testing. The business risk approach aims at a wider analysis of a client's risk profile in order to better assess the risk of material misstatements in its financial statements. A prominent issue in the discussion of audit approaches is the risk assessment practices of audit firms. Mariani et al. examine the effect of external auditing in the corporate world, and conduct an empirical analysis on a sample of companies, aiming at assessing: (i) whether external auditors (compared to statutory auditors) generally granted a higher quality of auditing; and (ii) whether the choice made by the Italian legislator to maintain the statutory auditors as financial auditors for selected

companies can impact negatively on the 'reliability' of their annual reports. The reliability of an annual report should be directly related to the efficiency of auditing activities. Blay et al. use a measurement for timing that equals the proportion of total revenue testing hours conducted at the auditee's fiscal year-end, and categorize audit evidence based upon its independence where more independent information is deemed to be more persuasive. Bedard et al. examine external auditors' perspectives on information systems risk in their actual audit clients. Research on systems risk is important in gaining an understanding of how systems can be improved.

2. An International Approach to Auditing

Abdullatif and Al-Khadash hold that the international audit firms generally apply a set of international quality control criteria to be applied in every individual country in which they operate. Although most business risks will have an effect on the client's financial results, some may even have a direct impact on the financial statements. The auditor concentrates on the factors, events and conditions that may prevent the company from achieving its business objectives. The adoption of the business risk approach has led to changes in planning and executing audit programmes. Clients with high risks, and particularly higher business risks, have to pay higher audit fees. The international process to auditing serves the large audit firms by assuring multinational clients of the quality of their worldwide audit. An international audit approach includes a single audit methodology with narrow definitions of different steps of an audit. Abdullatif and Al-Khadash contend that an international approach to auditing would lead to increasing the level of quality of worldwide audits performed by the international firm. Cultural factors may have an important effect on the success of the international audit approach. International audit firms have to ensure the quality of their audits worldwide.

Abdullatif and Al-Khadash show how the big firm audit is executed in a developing country, how that can be different from audits in more developed countries, and how appropriate the adoption of an international audit approach by a large audit firm might be. A main problem facing auditors in Jordan is the relatively low level of audit fees. The main arguments for a high demand for an audit do not exist in the Jordanian environment. The existence and nature of

the affiliation with an international audit firm have a significant influence on what audit approach the Jordanian audit firm adopts (the nature of the audit approach applied by an audit firm in Jordan depends to a large extent on the type and the strength of the affiliation with an international audit firm). As Abdullatif and Al-Khadash put it, audit firms which adopt a full or partial business risk approach in Jordan consider and assess multiple business risks (applying a business risk approach is likely to lead to more risk assessments with unfavourable outcomes). International audit firms which promote an international audit approach face a challenge in ensuring that their approach is well followed by all of their international offices. Stationing expatriate personnel in foreign countries where audit quality is a concern may be a part of improving audit quality. Although the firms assess the business risk factors, they do not tend to take them seriously when making subsequent audit decisions.¹

3. The Degree of Independence of Board and Audit Committees within the Client Corporate Governance

Mariani et al. stress the need for statutory auditors and external auditors to work in close contact and communication. Audit quality is positively related to the degree of independence of board and audit committees within the client corporate governance. Auditors' behaviour is less strict when their clients have hired a significant number of the audit firm's alumni. Total accruals are calculated as the difference between accounting earnings and operating cash flows. Revenue changes are an objective measure of a firm's operations before managers' manipulations. Mariani et al. write that firms with the largest absolute value of total accruals will show higher discretionary accruals. Financial statements audited by external auditors are more reliable than those audited by statutory committees. Italian auditors tend to adopt a particularly careful and critical approach, including in the reporting of even potential losses. There is a statistically significant difference regarding the sign of discretionary accruals in financial statements audited by external auditors (they show negative discretionary accruals) and those audited by statutory committees (they show positive accruals instead).²

4. The Linkage between Assessed Risks and Planned Audit Effort

Blay et al. uses audit workpaper evidence from a Big 4 accounting firm to provide evidence on the linkage between assessed risks and planned audit effort, and examine whether inherent and control risks *assessed separately* explain audit planning decisions (nature, timing and extent) better than a single, aggregated measure of misstatement risk. Risk assessments affect the nature, timing and extent of audit procedures, thus affirming the decision made by the Auditing Standards Board. Blay et al. address the question of whether the aggregation of inherent and control risks into one measure (misstatement risk) impedes auditor decision-making. The *nature* of audit testing addresses the type of testing conducted, *timing* decisions pertain to when tests are performed, and *extent* pertains to the amount or scope of testing. The disaggregation of risk assessments will provide better guidance to auditors for audit planning, and will contain more information that should be considered in evidential plans.

Blay et al. examine whether an aggregated measure of misstatement risk explains audit planning decisions as well as the disaggregated assessment of inherent and control risk. In the case of nature and extent, misstatement risk does not provide the same explanatory power that IR and CR separately provide. Higher preliminary risk assessments are related to the collection of more persuasive evidence (nature), more year-end evidence (timing), and more evidence (extent). Nature, timing and extent decisions are interrelated. Studies modeling evidential planning decisions as independent may not account for the interdependencies between nature, timing and extent.³

5. The Auditor's Evaluation of a Client's Systems Risk

Bedard et al. use auditors' evaluations of their clients' systems risk factors as a source of data on the difficulties frequently seen in company systems. Increased awareness of risk factors provide company managers and system developers with greater opportunities to devise and implement appropriate and adequate controls during the development process. Bedard et al. examine two specific areas of information systems risk: management information quality and EDP security. Bedard et al. document the frequency of specific system

and client characteristics that auditors identify and consider when planning for a sample of actual engagements, assessing the association of specific types of risk factors with auditors' risk assessments, and with decisions to plan various types of audit tests. For a very high proportion of clients, auditors identify at least one risk factor in the EDP security and management information areas. System-specific types of risk factors are statistically associated with planning of both tests of controls and review/inquiry procedures. Bedard et al. contend that the auditor's understanding of internal control supports a key audit strategy decision that must be made in every engagement. In both risk areas, audit effectiveness will be increased if related risk factors are identified. Auditors should respond to engagement risks by increasing their risk assessments and altering the nature, timing, and extent of audit procedures. Auditing standards indicate that auditors should adjust the audit plan to reflect client risk factors.

Bedard et al. provide descriptive evidence on the number and nature of systems risk factors that auditors identify for actual clients, and the relationship of those risk factors to risk assessments and audit testing. Auditors' risk assessments in both EDP security and management information areas increase when system or company-level factors are identified. Risk judgments in the management information area of systems risk are better calibrated. Auditors may have more experience in making unassisted assessments of the level of risk associated with problems concerning the nature of a client's management information. Clients with higher business risk (i.e., relatively poor financial health) tend to have higher EDP security risk. Bedard et al. point out that investigating systems risk through substantive or control tests is relatively rare compared with review/inquiry. When the number of risk factors is controlled for, the level of the risk assessment provides no incremental explanatory power regarding audit test planning. Within the EDP security risk area, system-specific factors are clearly the only type of factor that drives testing decisions. Within the management information risk area⁴, company-level factors are associated with planning of both review/inquiry and substantive tests. When viewing the risks associated with the quality of information provided by a system⁵, auditors tend to focus on the characteristics of the people and the organization.⁶

6. Conclusions

Abdullatif and Al-Khadash reason that a business risk approach may be appropriate in principle, but yet the nature and weight of the risks to be evaluated may have to differ among different environments. Due to low audit fees, the audit firm may consider ways to compensate for the additional costs of business risk assessment by finding ways to reduce the cost of substantive testing. Mariani et al. focus on the relationship between the overall auditing quality and auditors' independence and personal skills, assessing the auditing quality in medium-sized enterprises, where auditing companies are rarely in charge for the auditing process, replaced by sole auditors or less complex bodies. Blay et al. cumulate the independence scores for each procedure to develop a score for the *total* evidence gathered (this metric provides a better measurement of nature based upon the Public Oversight Board Panel on Audit Effectiveness definition). Bedard et al. demonstrate the usefulness of auditors' evaluations of their clients' systems risk as a source of data for future research in this area.

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CORPORATE GOVERNANCE EFFECTIVENESS AND QUALITY OF EXTERNAL AUDIT

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ABSTRACT. Stefaniak and Robertson investigate whether two interactive factors (the significance of the audit mistake and the anticipated professional repercussions of mistake admission) influence the likelihood of disclosing an audit error. Lin and Hwang test the effects of two levels of audit committee independence (complete and proportional independence), and find both to have a significant effect in reducing earnings management. Cahill remarks that the activities of internal audit and the audit committee of non-executive directors are critical elements in the assurance process. Hüpkes contends that external auditors will commit a capital offence if they fail to collect and analyse critical financial and behavioural data.

JEL: G34, M41, M42

1. Introduction

Stefaniak and Robertson investigate the effects of mistake significance and superiors' historical reactions to mistake admissions on the likelihood that staff auditors will admit mistakes. Staff auditors are more likely to admit errors when their superiors have reacted positively, regardless of error significance. Lin and Hwang apply meta-analytic techniques to empirical data from 48 studies that examined relationships between corporate governance and audit quality variables and earnings management. Pierce and Sweeney identify a need to examine the impact of demographic variables on ethical decision making. Hüpkes states that the audit is divided into a financial audit and a regulatory audit. The nature of the external auditors' involvement in the supervisory process differs significantly across countries.

2. The Significance of the Audit Mistake and the Anticipated Professional Repercussions of Mistake Admission

Stefaniak and Robertson investigate whether two interactive factors (the significance of the audit mistake and the anticipated professional repercussions of mistake admission) influence the likelihood of disclosing an audit error. Deliberate AQRA sometimes are undetected by both supervisors and by the firm review process. Stefaniak and Robertson investigate the potential professional repercussions of admitting to a mistake by manipulating the superior's historical reactions to mistake admissions, and predict that the likelihood of staff auditors admitting to their mistakes is lower (higher) when their superiors have historically reacted negatively (positively) to mistake admissions. The likelihood that staff auditors will admit to mistakes is positively related to the significance of the mistake. Auditors are expected to be sensitive to the superiors' historical reactions, but only when their mistakes do not affect audit quality.

Stefaniak and Robertson investigate auditors' responses to their mistakes made during previous audit procedures, focusing on the retrospective response of misrepresentation, and the likelihood that auditors will misrepresent mistakes already made by withholding evidence that could be detrimental to their professional image. The use of performance reviews yields benefits for audit firms. Auditors are conscious of their professional image when considering interactions with higher-ranking auditors. Staff auditors are sensitive to the potential negative professional repercussions of admitting to mistakes. Auditors generally avoid decisions that increase the risk that an audit will fail to detect a material misstatement. Staff auditors are sensitive to superiors' historical reactions when their mistakes do not appear to affect the quality of the audit. Stefaniak and Robertson examine the sensitivity of the results to the phrasing of the dependent measure. Negative superior historical reactions exacerbate the perceived negative professional consequences of disclosing mistakes. Staff auditors believe they have a greater professional responsibility to report a mistake as the significance of the mistake increases.¹

3. The Effects on Earnings Management of Factors Relating to Corporate Governance Effectiveness and Quality of External Audit

Lin and Hwang test the effects of two levels of audit committee independence (complete and proportional independence), and find both to have a significant effect in reducing earnings management. Lin and Hwang provide an overview of research on the effects on earnings management of factors relating to corporate governance effectiveness and quality of external audit. Properly structured corporate governance mechanisms reduce earnings management (they provide effective monitoring of management in the financial reporting process). A properly structured and functioning audit committee reduces opportunistic earnings management.

Lin and Hwang maintain that a quality audit constrains opportunistic earnings management and reduces information risk that the financial reports contain material misstatements or omissions. Effective governance and financial reporting quality increase with board independence. No significant relationship exists between stock ownership by directors and earnings management. The existence of an audit committee indicates higher quality monitoring.²

4. Length of Experience and Ethical Decision Making

Pierce and Sweeney examine the impact of a range of demographic variables on trainee accountants' intentions to engage in, and judgments on, various time pressure-induced dysfunctional auditor behaviours. The relationship between length of experience and ethical decision making is not a simple positive or negative linear relationship. Pierce and Sweeney use multi-item measures for magnitude of consequences and social consensus and find the strongest evidence linking these dimensions to the ethical reasoning process. Firm size is significantly related to perceived ethical culture. Further education has only a limited impact on ethical views of trainee accountants. Differences in ethical intensity depending on the length of experience are not significant. There may be categories of employees who perceive greater pressure and have lower ethical decision-making skills. Demographic variables have an important influence on ethical decision making. The impact of the variables is dependent on the context of the ethical situation.³

5. Auditors' Judgments about Extended Audit Procedures

Schneider examines whether internal auditor incentive compensation and stock ownership affect internal auditors' decisions to extend audit procedures when warranted (internal auditors may be reluctant to extend audit procedures in situations that could adversely impact the company's earnings), investigating potential objectivity impairment when internal auditors receive earnings-based compensation or own stock in the companies in which they are employed. Internal auditors who own company stock or stock options might tend to overlook management actions that overstate earnings. Company investors and creditors increasingly rely on the monitoring activities of internal auditors. Schneider examines the effects of incentive compensation and stock ownership on internal audit procedures.⁴

6. Audit Committees as the Cornerstone of Internal Governance and Control

Cahill remarks that the activities of internal audit and the audit committee of non-executive directors are critical elements in the assurance process. Cahill examines how the internal governance systems and structures in one of the four Irish clearing banks could fail to correct a variety of "improper practices". Cahill addresses the media background to the bank's irregularities and irregularities in the wider banking system. Cahill discusses the broad roles of internal audit and the audit committee together with the actual roles and work of these groups in the NIB, suggesting the possible causes of internal governance breakdown. The Irish clearing banks are linked by a myriad exchange transactions, similar types of customers and a common financial regulator. The internal audit reports and the work and minutes of the audit committee confer legitimacy on the quality of assurance on the bank's internal controls. Strong internal control systems are particularly relevant to banks, involving the separation of responsibilities, the monitoring of activities, and the review of the adequacy of systems to ensure that risk exposure is transparent and within agreed policies. Audit committees are the cornerstone of internal governance and control. The interaction between the audit committee and internal audit is crucial in ensuring effective internal controls and compliance with relevant laws and codes of best practice. Cahill sees audit committee and the language it uses to describe

issues as a form of symbol that has its own meaning and interpretation.⁵

7. The Success of Banking Supervision

Hüpkes contends that external auditors will commit a capital offence if they fail to collect and analyse critical financial and behavioural data. The success of banking supervision depends on having the essential information and the external auditor is a key provider of the requisite information. The Swiss supervisor relies to a significant extent on the external auditors' "collection of information". Hüpkes explores the particularities of the Swiss supervisory system and discusses how it has evolved from a purely dualistic system to a more hybrid one (the merger of the monolithic and dualistic approaches creates challenges with respect to the delineation of responsibilities between the supervisor and the auditor). External bank auditors must restrict their activities exclusively to auditing and related professional services. Auditors are subject to the same professional secrecy norm as banks. Hüpkes points out that in the event that the audit reveals violations of legal provisions or any other irregularity, the external auditor sets an appropriate deadline for the bank to take corrective action. A mechanism should be in place to facilitate discussions between the supervisors and the external auditors (they should have a clear understanding of their respective roles). The system of indirect supervision provides for the most effective means of collecting and analyzing critical information⁶ on the soundness of the financial institution. The audit firm has a statutory responsibility to perform functions that serve to protect depositors.⁷

8. Conclusions

Stefaniak and Robertson remark that assessing the significance of a mistake is a subjective process that could have unforeseen consequences, and that audit firms have some ability to control the vulnerability that individuals feel when their performance is unsatisfactory. Lin and Hwang write that stock ownership by AC members may reduce the effectiveness of the audit committee in monitoring management in the financial reporting process. Non-audit fees per se are less important than their relationship to the total fees

paid to the auditor in determining earnings management. Pierce and Sweeney examine the impact of a range of demographic variables on ethical judgement, ethical intention, perceived ethical intensity and perceived ethical culture. Understanding differences arising from demographics may allow firms to tailor their ethics training to specific groups. Hüpkes explains that both the supervisor and the shareholders seek to ensure the efficient and honest conduct of business by management, ensuring an adequate level of profitability and the continuation of the business.

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BRAIN DRAIN AND UNDERDEVELOPMENT

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ABSTRACT. Kahanec et al. identify the main scientific and policy challenges concerning migration in the enlarged EU. Rosenow focuses on the developments that led to the “surprising” emergence of integration policies as a new policy field at the EU level. Sahay holds that host countries have policies that encourage or provide the necessary conditions for brain drain to take place. Kuhn and McAusland introduce differences in intellectual property rights, showing that (a) weak domestic IPRs accentuate the gains from knowledge worker emigration, and (b) if source country IPRs are chosen endogenously, BBD becomes even more likely than in the base case.

JEL: E24, F22, J62

1. Introduction

Kahanec et al. hold that there is no simple link between the scale of migration and the transitional arrangements (the proportion of non-EU27 nationals in the EU15 remains larger than that of migrants from the new member states). Rosenow examines the diverse influences that fostered the slow process of change that led to the decision in Tampere in 1999 to grant TCNs rights comparable to EU citizens. Sahay emphasizes that developing countries need to take advantage of the training opportunities in the developed world. Kuhn and McAusland study the direct benefit to sending-country consumers that occurs when its brains move to an environment where they produce higher-quality knowledge goods.

2. The Determinants and Effects of the Post-enlargement Migration Flows

Kahanec et al. identify the main scientific and policy challenges concerning migration in the enlarged EU. High-skilled emigration increases wages in the high-skilled market and via complementarities. Geographical and linguistic distance as well as networks are very important pull-factors. The proportion of individuals with tertiary education is larger among those migrating after enlargement. Kahanec et al. examine whether a correlation exists between migration flows into Germany and the GDP per capita and unemployment rates of the sending countries (both GDP per capita and the unemployment rate are significant push-factors). Recent EU8 immigrants in Germany exhibit lower employment and participation rates. The share of employed among EU8 migrants in the EU15 is larger for cohorts arriving after enlargement. The employment rate is almost the same for pre- and post-enlargement EU8 immigrants in Germany. The higher unemployment rates for the most recent EU8 migrants arise largely because they are relatively young. The composition of EU8 immigrants has changed since EU enlargement. Language and cultural barriers play key roles as factors deterring intra-European migration. Immigration from the new member states to the EU15 has risen after enlargement. The inflows of nationals from the new member states to the UK and Ireland have slowed down in 2007 and 2008.

Kahanec et al. examine the aggregate labor market statistics to identify the main trends before and after the recent enlargements. There is no evidence of a significant slow-down of employment growth after the 2004 enlargement until at least 2007. Immigration from the new member states has had little impact on wages and employment. There is small impact of the recent immigration from the new member states on the UK unemployment rate or wages. Post-enlargement mobility has substantial positive effects for the EU as a whole in terms of GDP. Skilled immigration from the new member states may improve the inequality situation in the old EU15 in the long run. Immigration may alleviate the demographic burden (immigrants from the new member states may decrease the fiscal burden of future resident generations). Several new member states have experienced significant outflows of relatively young and skilled people. Kahanec et al. point out that labor migration from the new

member states has increased since enlargement. There is a tendency of increasing enrolment rates for tertiary education in the new EU member countries. Remittances constitute a significant part of the GDP in Bulgaria and Romania. The remittances are mostly seasonal in nature in Poland and the Baltic states. Some deterioration of labor market variables have been observed in the destination countries. The crisis is affecting the new member states and potentially will cause a slowdown there in vacancies and employment growth. Mobility barriers are known to decline in the EU over the next years. An increase in unemployment will reduce the availability of valuable information. Kahanec et al. claim that migrants face a deepening of the crisis in both the host and home countries. High skilled immigrants are more likely to return home than low-skilled immigrants who cannot expect to find a job back home. The Eastern enlargement of the EU removed some of the institutional migration barriers. The increase in immigration from the EU8 was largest in Ireland and the UK. The migration trajectory is of a temporary nature. The anticipated brain circulation may help solve demographic and economic problems in their countries of origin. Free migration should alleviate many consequences of the crisis. Circular migration may affect technological advancement in both source and destination countries. Barriers applied in Germany discouraged the most skilled migrants and lowered the average quality of the migrant inflows.¹

3. The Distribution of a Common EU Integration Policy

Rosenow focuses on the developments that led to the “surprising” emergence of integration policies as a new policy field at the EU level, and analyses the early developments on the European level regarding the rights of TCNs, highlighting the pioneering initiatives taken by the Council of Europe, as well as the first steps taken by the European Commission, the European Parliament, and the NGOs. The obligatory adoption of the *acquis communautaire* by the new member states is one example for the formal pressures that led to the distribution of a common EU integration policy. Rosenow shows the marginal progress made in the EU framework towards the inclusion of rights for TCNs in the political agenda. The European Commission and the European Parliament were severely restrained to foster a common integration policy agenda. The European Commission tried to gain the confidence of the nation states for supra-

national solutions. The exclusion mechanisms available to member states are limited to the point that TCNs benefit from EU-wide transferable rights. The nation states did not give up their control over the speed of the supranationalisation process. The ability of a skilled social actor to create a consensus among the other actors involved is not restricted to non-governmental actors.

Rosenow argues that the NGOs, the European Parliament and the European Commission played the role of an innovator and creator of new ideas. The nation states decide on the pace of implementation and the agenda-setters have to orient their actions towards their interests. The link between a successful integration and economic and social advantages became one of the standard frames employed in order to support the extension of rights to TCNs. The challengers tried to frame the perception of integration policies by linking it with issues of employment and social cohesion. The emergence of an integration policy agenda is an example for the potential to further integrate European policies despite national scepticism.²

Sahay holds that host countries have policies that encourage or provide the necessary conditions for brain drain to take place. Brain drain captured the attention of policymakers worldwide beginning in the decade of the 1960s. Skills are tied to people and can constitute a subset of brain drain. Migration of people has been replaced to some extent by the migration or outsourcing of jobs. The core of the interest in the migration of the highly skilled remains “*economic*.” Sahay states that brain drain reduces professional manpower in the developing countries and can have the effect of easing population and employment problems there. Governments in sending countries have done quite a bit in addressing the problem of brain drain. Brain drain has been associated with underdevelopment (any discussion linking brain drain to underdevelopment needs to ask how extensive is this brain drain and how can this lost human capital be utilized to augment development in the sending country). Brain drain occurs from countries that have reached a level of development and are advancing in the development path. Sahay asserts that implications for brain drain become pertinent when looking at voluntary migration by individuals. The fear of brain drain has been receding in many countries. The characteristics of temporary admissions of aliens should not normally affect the discussion on brain drain. Brain drain induces positive feedback effects such as remittances, return, and transfer of technology through networks. Sending countries

encourage the return flow of people and capital (this offsets some negative effects of brain drain). The discussion on brain drain focuses on the broad statistical implications of exit and entry. The role of the sending country takes on new dimensions with increasing brain gain strategies.³

Jenkins et al. claim that health worker migration matters: human resources are fundamental to the delivery of health services. There have been substantial losses through brain drain to the richer countries, who derive significant proportions of their health workforce from poorer countries. Jenkins et al. assess the scale of the brain drain of psychiatrists to four high-income countries (UK, US, Australia and New Zealand) and estimate its impact on the population ratios of psychiatrists in donor countries. Jenkins et al. document large numbers of psychiatrists currently registered in high income countries who originate from low and middle income countries (A comprehensive approach of international agreements to mitigate harm to the supply of health workers in low and middle income countries is crucial).⁴

4. Source Countries' Gains from Brain Drain

Kuhn and McAusland introduce differences in intellectual property rights, showing that (a) weak domestic IPRs accentuate the gains from knowledge worker emigration, and (b) if source country IPRs are chosen endogenously, BBD becomes even more likely than in the base case. The strength of a country's IPRs can be measured along the breadth of its fair use rules, and the zeal with which it enforces its rules. For *any* fixed source IPR policy, the only effect of brain drain on Source consumers is via its effects on the quality and appropriateness of the knowledge good. If Source has low IPR protection for reasons that lie outside Kuhn and McAusland's model, Source's interests are more likely to involve sending its knowledge workers abroad and consuming better entertainment, science and technology as a result. Kuhn and McAusland ask how their main results regarding the optimality of beneficial brain drain in the limiting case where they allow countries to optimally adapt their IPR policies to their emigration policy regime (not all important factors affecting optimal IPR policy are included in Kuhn and McAusland's model). As Kuhn and McAusland put it, in the late twentieth century,

the worldwide pattern of information goods production and IPR protection had three distinct features: knowledge goods production was highly concentrated in a single country with a large domestic market, a significant share of these goods was produced by immigrants to that country, and intellectual property rights protection was strongest in the producing country and weaker in other countries, including the source countries from which migrating knowledge workers were drawn. The international specialization derives simply from differences in domestic market size and home bias in tastes. Source countries' gains from brain drain depend on intellectual property rights in both the sending and receiving countries. The consumption benefits⁵ to sending countries of knowledge produced⁶ by expatriates have tended to be ignored.⁷

5. Conclusions

Kahanec et al. discuss the theoretical underpinnings of migration causes and effects, describe the post-enlargement migration flows, and investigate their impact on the receiving and sending countries including the impact on the European growth potential. Rosenow investigates the creation of this new EU policy field with a focus on the actors and interests that fostered its outcome. Sahay focuses on both political and economic advantages that can come from brain drain. Kuhn and McAusland endogenize IPR policy by characterizing a (potential) sending country's best combination of emigration and IPR policies.

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THE ROLE OF REGULATION IN BRINGING ABOUT EFFICIENCY IMPROVEMENTS

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ABSTRACT. Levine et al. hold that clear and open regulatory procedures are the essential foundation of fair and effective regulation by telecom and other utility service regulatory agencies. Geradin claims that liberalization has significantly modified the regulatory framework applicable to network industries and has introduced many significant changes in the organization of network industries. Parker holds that privatization is expected to lead to lower costs of production and a higher quality of service to consumers. Majone writes that the external powers of federal governments are typically broader than their purely domestic powers.

JEL: D85, L14, L33

1. Introduction

Central banks with superior governance arrangements, particularly on accountability and transparency, out-perform those with inferior arrangements, and Levine et al. discuss how this work might be extended to utility regulatory agencies. Geradin explains that prior to liberalization, network industries were generally dominated by public monopolies. Parker provides a better understanding of regulation for policy makers, academics and managers in countries currently considering utility privatisation. Majone discusses the credibility problems created by the expansion of Community competences and by the Community's limited external powers.

2. Independent CBs and Regulatory Agencies

Levine et al. explore the similarity of the underlying economic problems that lead to the establishment of (a) independent central

banks to operate national monetary policies and (b) independent regulatory agencies for telecommunications and other utility service industries. The adoption of agencies independent of government results from the need to achieve credibility and a reputation for economically sound long-run behaviour while preserving significant discretion to handle unanticipated events. Levine et al. show that this solution is superior to policy rules that are fixed in advance. Independent central banks are associated with better macro-economic outcomes (for example on inflation and exchange rate volatility). Levine et al. distinguish between three types of problems facing central banks, regulators and other public authorities: (i) the credibility of commitment; (ii) asymmetric information in relation to the private sector; (iii) non-benevolence arising, for example, from electoral pressures or capture by special interest groups. Countries which assign monetary policy to an independent central bank have lower and less variable rates of inflation. The statistical association between assigning monetary policy to an independent central bank and low inflation may or may not be causal. Countries which are more inflation averse or which place more weight on having a sound economic policy choose to have an independent central bank.

In order to examine the under-investment or “hold-up” problem, Levine et al. set out a simple model of the regulatory pricing problem for private sector utility services such as telecoms: there exists a close parallel between the inflation bias in the conduct of monetary policy and a high price bias arising from the under-investment problem in utility regulation. Protecting the rights of investors reduces investment risk premia and the cost of capital. The underlying rationale for an independent utilities regulator and an independent central bank is extremely similar (there may be similarities between the proposed ways of creating an institution which can establish and maintain a credible reputation for making and keeping commitments in a way that governments find difficult to do). Rogoff-delegation allows full discretion for the regulator to engage in period-by-period optimization based on all information available at the time the price decision is made. Levine et al. hold that clear and open regulatory procedures are the essential foundation of fair and effective regulation by telecom and other utility service regulatory agencies. Regulatory agencies should operate by simple rules and have no (or minimal) discretion. Proper regulatory governance arrangements are crucial. Regulatory systems work bet-

ter where independent regulatory agencies are given (limited) discretionary powers. It is difficult to construct good tests of an independent regulatory agency analogous to the simple inflation rate test for an independent central bank. Developing and transition economies may not absolutely need an independent regulatory agency to generate some private investment in telecoms. Levine et al. say that both independent CBs and regulatory agencies can be difficult to sustain in many environments. It is rare to find countries with independent telecom regulatory agencies that do not also have independent CBs operating monetary policy. Regulation is inherently about the monitoring and enforcement of the behaviour of commercial companies according to licence conditions or equivalent obligations.¹

3. The Regulatory Framework Applicable to Network Industries

Geradin explains why for almost a century firms involved in network industries generally took the form of State monopolies, that to be successfully completed the liberalization process should rely on three pillars (the removal of exclusive rights, the adoption of a regulatory framework and the setting-up of independent regulatory authorities), analyzes the current state of liberalization in the different network industries, and explores three significant changes in the organization of network industries and on market structures (the vertical unbundling between infrastructure and services, the breaking down of the barriers between network industries, and the progressive withdrawal of the State in such industries). Geradin claims that liberalization has significantly modified the regulatory framework applicable to network industries and has introduced many significant changes in the organization of network industries. Full unbundling of the network is the preferable solution from a competition standpoint (it eliminates incentives to discriminate). Liberalization has stimulated the creation of new products and services, generating a range of new markets populated with new firms. Liberalization and privatization should not mean a complete withdrawal from the State in network industries markets. Network industries are very sensitive to regulation. The EU system relies on the implementation of regulatory obligations through national agencies. There exists a degree of asymmetry between the levels of independence, competence, resources, and accountability of the national agencies. Geradin remarks

that national authorities seem poorly adapted to deal with cross-border issues.²

4. The Results of Privatisation and Regulation for Consumers and Investors

Parker holds that privatisation is expected to lead to lower costs of production and a higher quality of service to consumers. Natural monopolies exist where there are important economies of scale in production. A natural monopoly might exist where there are appreciable economies of scope. Two or more activities are more economically supplied by one firm than by competing firms. Telecommunications, water and sewerage, gas, electricity and railways are associated with some natural monopoly characteristics. Parker looks at the results of privatisation and regulation for consumers and investors and at the main governance issues that arise when private ownership and state regulation are combined. UK has introduced a system of “independent regulation” that has become something of a model for other countries. UK’s experience needs to be assessed in the context of each country’s particular political, social and economic circumstances. Private capital is necessary to fund badly needed investment programmes at a time of government budgetary pressures. Countries have found that distancing telecommunications from day-today state intervention has become essential. State ownership is associated with “low powered” incentives to be efficient, lacking both a private competitive capital market and product-market competition. In a competitive product market inefficient suppliers will fail to attract customers and therefore will not survive. Inconsistent and opaque regulation frightens-off investors and stymies the development of product competition.

Parker maintains that state ownership frequently involves day-to-day intervention by ministers and Civil Servants in the detailed or micromanagement of enterprises. Compared with direct state ownership and control, the transaction costs of regulating monopolies are reduced. The evidence from the UK confirms that under privatization with regulation real economic gains can be obtained. Where political risk is high, the cost of capital raising in the private sector is increased. In the USA transparency is achieved through public regulatory hearings. US regulation is more deeply embedded in the legal system than is the case in the UK. Developing countries

wishing to attract foreign capital into their utility industries must ensure that the framework for regulatory consistency exists. Institutions are reflected in the ideology, beliefs and mind set of society, including formal constraints, notably laws, constitutions and rules, as well as informal constraints. Parker says that institutions are a product of both social, economic and political history and current conditions, and determine the context within which economic transacting occurs. The institutional context is critical to an understanding of regulatory legitimacy. Institutional contexts need to be compatible with regulatory independence. Regulatory learning occurs in both regulated offices and the companies. Regulatory governance reflects the political, social and economic traditions, practices and constraints of the economy in which it is situated. Legitimacy is contingent on the institutional context (it cannot stand separate from it).³

5. The Present Highly Decentralized System of Community Regulations

Majone addresses two specific threats to credibility: the mismatch between the Community's highly complex and differentiated regulatory tasks and the available administrative instruments; and the problem of credible commitment caused by the increasing level of politicization and parliamentarization of the Commission. The solution to both sets of problems may be found in a more far-reaching delegation of powers to independent European agencies embedded in transnational networks of national regulators and international organizations. The present highly decentralized system of Community regulations cannot compensate the lack of credibility of some national regulators and cannot provide a credible countervailing force to the power of the former state monopolies. The Community faces serious problems when it seeks to establish itself as a credible actor in the arena of international regulatory cooperation. Majone writes that the external powers of federal governments are typically broader than their purely domestic powers. Regulation requires detailed knowledge of, and intimate involvement with, the regulated activity. The evolution of drug regulation in the EC shows the limits of the traditional decentralized approach. The need of stronger and more autonomous regulatory institutions is becoming more urgent. The credibility and coherence of European regulatory law depends on the

perception that the Commission is able to enforce the common rules in an objective and even-handed way.

Majone affirms that the enforcement of European law does not depend exclusively on Commission supervision. The EC policy process has always been to some extent politicized. The policies of the current majority can be legitimately subverted by a new majority with different and perhaps opposing interests. The progressive politicization and parliamentarization of the Commission raise the issue of credibility at the European level. The delegation of powers to regulatory bodies distinct from the Commission itself may provide a feasible solution to the credibility problem under the new political conditions prevailing in the Union. Direct oversight of agency behavior needs to be supplemented by more indirect and less costly mechanisms of a procedural nature. There are many substantive and procedural means by which independence⁴ and accountability⁵ can be made to be mutually reinforcing.⁶

6. Conclusions

Levine et al. contend that regulation must operate within a general competition framework and may in time be replaced by general ex post competition policy. Independent central banks operating monetary policy are associated with lower and less variable inflation. Geradin thinks that regulation places restrictions on their behavior and generates implementation costs. As markets become increasingly competitive, sector-specific rules should progressively disappear. Parker looks at the specific role of regulation in bringing about efficiency improvements. The UK experience reveals that regulation is a complex balancing act between advancing the interests of consumers, competitors and investors. Majone stresses that the new European agencies are expected to become the central nodes of networks including national agencies as well as international organizations.

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THE APPLICATION OF MATHEMATICAL MODELS IN DESCRIBING REAL ECONOMIC PROCESSES

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ABSTRACT. Zhang uses computer simulation to demonstrate motion of economic systems. Benson demonstrates that an import tariff can lead to falling prices in the domestic economy, depending on the assumptions about demand functions and behavioral strategies. Giocoli asserts that economic analysis in the general equilibrium tradition has reduced itself to a mere mathematical exercise. van Daal and Jolink deal with mathematics in economics, free competition, and price determination under a regime of free competition and utility. Janssen et al. cover financial mathematics in a deterministic context, assuming that the monetary income and outcome movements will happen and in the prefixed amount. Sriboonchitta et al. are concerned with decisions based upon stochastic dominance rules in financial economics.

JEL: C23, O31, R15

1. Introduction

On Zhang's reading, the theory of differential equations has become an essential tool of economic analysis. The growth rate is affected by many factors, such as the current state of the economic system, accumulated knowledge of the economy, international environment etc. Sriboonchitta et al. write that economists have raised concerns about the applicability of von Neumann-Morgenstern's model to all real-world problems.

2. Modeling and Understanding the Time Evolution of Nonlinear Dynamic Economic Systems

Zhang uses computer simulation to demonstrate motion of economic systems. Nonlinear dynamical theory has found wide applications in different fields of economics. Zhang presents the mathematical theory in linear and nonlinear differential equations and its applications to many fields of economics. Zhang claims that the society may

suffer from poverty due to over population if its economic growth fails to meet the basic need of the rapidly increasing population (an economic system often contains many dependent variables, such as outputs, capital stocks, money, and prices) and that the logistic differential equation is not proper for describing interactions between economic growth and population dynamics. Zhang introduces some economic mechanisms to avoid the decline of living standard, examines a dynamic model to see how leisure time and work hours change over time in association with economic growth, and examines dynamics of sexual division of labor and consumption in association of modern economic growth, illustrating increases of women labor participation as a “consequence” of economic growth as well as changes of labor market conditions.

Zhang considers population as independent of economic conditions, examines effects of changes in some parameters on the economic growth and geography, and remarks that a way to explore evolution of time distribution is to consider possibility of value change as an endogenous process of economic evolution. Zhang examines dynamic behavior of some typical economic models, such as the competitive equilibrium model, the Cournot duopoly model with constant marginal costs, the Cournot duopoly model with increasing marginal costs, the Cagan model with sluggish wages. Zhang deals with nonlinear planar differential equations, carrying out local analysis, providing conditions for validity of linearization and relations between linear systems and almost linear systems with regard to dynamic qualitative properties. Zhang examines dynamic properties of some frequently-applied economic models, such as the competitive equilibrium model, the Walrasian-Marshallian adjustment process, the Tobin-Blanchard model, and the Ramsey model.¹

3. Economic Analysis in the General Equilibrium Tradition

Benson demonstrates that an import tariff can lead to falling prices in the domestic economy, depending on the assumptions about demand functions and behavioral strategies, that mathematical theories can be manipulated to predict practically anything that the theorist wants to predict, simply by changing some assumptions, and that econometric analysis is just as easy to manipulate as mathematical model building. Benson states that model-builders who advocate policy based on their mathematical manipulations are similar to empirical

policy analysts (they generally do not want their normatively-driven policy prescriptions to be attacked) and that individuals and groups have two principal ways of augmenting their wealth, voluntary cooperation in joint production and trade, and taking wealth from others by force or guile. Benson contends that recognition of both kinds of incentives, to cooperate voluntarily and to transfer through coercion, enhance our understanding of institutions and their behavioral implications.²

Giocoli asserts that economic analysis in the general equilibrium tradition has reduced itself to a mere mathematical exercise (economic models have become totally non-descriptive). One can easily understand why economists have been so far quite selective in their efforts to encompass the experimental evidence. Success in modern economics is not necessarily dependent on a theory's explanatory power with respect to experimental results. Giocoli argues that the two poles of the transformation were the traditional image of economics as a discipline dealing with systems of forces and the new image of economics as a discipline dealing with systems of relations. In Giocoli's view, the new image of economic knowledge is not devoid of practical consequences.³

4. The Use of Mathematics as a Method of Analysis in Economic Theory

van Daal and Jolink deal with mathematics in economics, free competition, and price determination under a regime of free competition and utility (elements which are basic in Walras's theory of pure economics). According to Walras, in discussing the application of mathematics we should distinguish between application to economic theory and application to economic practice. In the case of pure economic theory we study and explain facts (the use of mathematics is motivated by the need for a *method of analysis*). In economic practice mathematics is used to evaluate certain consequences of an economic measure. van Daal and Jolink stress that in most cases Walras's mathematics should be regarded as a method of analysis in abstract terms, rather than as a method of calculation. Mathematics could be of practical relevance by formulating *general* rules.⁴

Lagerlöf and Seltzer examine the effects of remedial mathematics instruction on students' performance in economics subjects in a British context, inspecting students' grades in compulsory first-year sub-

jects ranging from the highly mathematical Quantitative Methods I to the nonmathematical Economics Workshop. Remediation may have a limited effect in increasing students' mathematical abilities. The amount of mathematics taken prior to university and the results in A-Level Mathematics have strong predictive power on student performance. Lagerlöf and Seltzer find a statistically significant effect only in the least mathematical course and the overall average of the first year and no effect in the second or third year of the program. Taking remedial mathematics has a limited effect on student performance in the more mathematical subjects. The existing Foundations of Mathematics program did little to affect student ability in mathematics. A successful remedial mathematics program might improve the performance of currently enrolled students and increase the demand to study the subject. Lagerlöf and Seltzer examine the impact of the implementation of a remedial mathematics program for students' performance in a variety of compulsory economics courses at Royal Holloway, University of London. For a range of courses, the amount of mathematics taken prior to university and the results in secondary-school mathematics have strong predictive power on student performance.⁵

Donnelly and Embrechts believe that there should be a reliance on sophisticated mathematics. The root of the Crisis was the transfer of the risk of mortgage default from mortgage lenders to the financial market at large. Many market participants either did not realize this was happening or did not think that it was significant. The coupon payments received by the holders of the CDO tranches depend directly on the defaults occurring in the underlying portfolio of assets. Donnelly and Embrechts believe that it is imperative that the financial world considers what the model they use implies about frequency and severity of extreme events. Models based on the normal distribution should be used in conjunction with several different models, some of which should adequately capture extreme events. Donnelly and Embrechts explain how AIG came close to bankruptcy and draw some relevant lessons from their risk management failures.⁶

Rosser examines the rising competition between computational and dynamic conceptualizations of complexity in economics: while computable economics views the complexity as something rigorously defined based on concepts from probability, information, and computability criteria, dynamic complexity is based on whether a

system endogenously and deterministically generates erratically dynamic behavior of certain kinds.⁷

Janssen et al. cover financial mathematics in a deterministic context, assuming that the monetary income and outcome movements will happen and in the prefixed amount. Janssen et al. formalize the indifference curves and the principle of financial indifference in objective terms, defining financial factors, rates and intensities for lending and discounting operations, in relation to the possible distribution of interest payments in the deferment period. In relation to a *financial* it is important to investigate the existence and the properties of regimes which are decomposable and uniform. Janssen et al. clarify the relation connecting the choice between two alternative projects and the *substitutive financial operations*, which are obtained formally as *difference operations* between two operations (of investment or financing).⁸

5. Existing Risk Measures in Economics

According to Sriboonchitta et al., an economic agent is: (i) risk neutral if, when facing two risky prospects with the same expected value, will feel indifferent, (ii) risk averse if, when facing two risky prospects with the same expected value, will prefer the less risky one, and (iii) risk seeking if, when facing two risky prospects with the same expected value, will prefer the riskier one. Some special stochastic orders of interest are termed stochastic dominance rules. Stochastic dominance refers to a set of rules to choose uncertain prospects (mostly in financial economics). The concept of stochastic dominance became known in economics in the context of investment. Managing risk in all sectors of an economy is the key to making organizations successful in delivering their objectives while protecting the interests of their stakeholders. For the needs of economic decisions we can provide a quantitative theory for risk behavior. Economists search for risk measures which should be based on the downside tail distribution of returns. In trying to quantify risks, we need to place ourself in a specific economic context. Any proposed risk measure should be consistent with appealing economic principles, such as reducing risk by diversification. In financial economics, we are dealing with random variables which are themselves considered as risks. Random sets can be used as models for coarse data in economics. Sriboonchitta et al. are concerned with decisions

based upon stochastic dominance rules in financial economics. Sriboonchitta et al. present the two main factors in statistical analysis of economic problems, namely models and data. Economic data are coarse in a variety of ways as well as rich in structure.⁹

6. Conclusions

Zhang introduces concepts, theorems, and methods in differential equation theory which are widely used in contemporary economic analysis, and is concerned with how differential equations can be applied to solve and provide insights into economic dynamics. Sriboonchitta et al. illustrate the justification of some models proposed in econometrics and financial economics. The individual units in an economy interact with each other (the observed data tend to reflect complex econometric equilibrium conditions).

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THE ECONOMIC IMPACT OF EMPLOYER INVESTMENT IN TRAINING

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ABSTRACT. Dawe outlines how large firms undertake training evaluation and measure returns on investment in training. Asplund explores the most recent research on the economic benefits arising from company-provided training. Rothwell et al. explain that trainers and HRD practitioners play an important role in national workforce development. Tai aims to understand how IBM develops, implements, and determines the effectiveness of e-learning.

JEL: J21, P33, M53

1. Introduction

Dawe states that individuals have been able to help identify their own particular training needs through the completion of individual training and development plans. An indication of successful training practices in large firms is the formal evaluation of training. Asplund argues that our knowledge on the interactions between formal education and employer-provided training is still weak. Rothwell et al. say that training programs cannot be expected to provide a bridge over all performance gaps. Managers are considered to be responsible for decision making about the types of training needed in their departments. Tai insists that funding for training mostly resides locally with individual businesses. In leadership training, there is an assessment for competencies.

2. Successful Training Practices in Large Firms

Bishop presents empirical evidence outlining the ways in which small businesses orientate themselves towards the training market, illuminating the factors influencing small firms' (non-) participation in formal, externally-provided training. The small firm's behaviour in relation to the training market is embedded in a complex web of social relations and subjective orientations. In highlighting the importance of social and subjective factors in constructing the small firm's behaviour in the training market, Bishop goes beyond the conventional focus on financial costs and returns.¹ Dawe reports on a study conducted by the National Centre for Vocational Education Research Ltd. (NCVER), "Determinants of successful training practices in large Australian firms", which examines the determinants of successful training and learning practices, and the factors that have influenced these practices in large Australian firms in recent times. Dawe outlines how large firms undertake training evaluation and measure returns on investment in training. The analysis of previous case studies finds ten major elements which contributed to successful training practices in large Australian firms: having in place an organizational culture that supports learning, linking training to the major features of a business strategy, responding to change within the organisation or external to it, increasing the diversity of training and learning approaches, sourcing formal training from within the organisation itself, adopting accredited training, often linked to the National Training Framework, increasing the use of informal training, decentralizing the training within the organization, responding to the needs of the individual, and evaluating the training. A supportive learning culture encourages individual development through its human resource practices. The linking of training to the business strategies leads to ensuring its relevance to individuals and corporate objectives. Dawe remarks that improving quality and consistency, and complying with occupational health and safety and environment standards, are part of sound business practice. Large firms may source formal training from within the organisation itself or import customised training from a range of external training providers. The key objective of the returns on investment in training evaluation model is to allow the company to identify the value of training to its profitability.²

3. The Economic Role of Company Training

Ketola holds that companies need to be socialized so that they would not hurt humans, damage human relations in/between societies, or soil the environment that we all depend on. Ketola shows how companies can be “potty-trained” to act clean by taking them through the eight sequential stages of psychosocial development towards genuine CSR.³

Asplund explores the most recent research on the economic benefits arising from company-provided training. Companies are usually willing to share both the costs and the benefits arising from investments in firm-specific training with their employees. Companies provide their employees with a considerable amount of general training, and also pay for this training. The company benefits more from the investment than the trained employee. Asplund contends that the employer’s interest in providing and paying for the general training of its employees is determined by the economic benefits that it can reap from the investment. Various labour market institutions give rise to similar situations as that produced by the non-competitive wage compression argument. Due to more compressed wages, European companies are more willing to bear the costs for general training than US companies. The probability of receiving employer-provided training increases substantially with the individual employee’s level of education. On Asplund’s reading, the supply of training (by employers) shows no variation with the educational level of employees. Both the incidence and the intensity of company-sponsored formal training vary considerably across occupations. Training needs are very different in different occupations and at different hierarchical levels. The extent of training tends to be positively related to the size of the employer. Substantial differences in the provision of formal training programs are evident across single industries. The company’s efforts to reduce turnover are taken to be driven by its need to impart specific skills. In a competitive labour market, there is no specific relationship between general training and turnover.

Asplund explains that employees who are perceived to have a high probability of leaving the company are less likely to receive employer-provided training. Training might increase an employee’s probability of leaving the employer. The standard human capital model distinguishes between general and specific training. Em-

ployer-provided training stands out as a potentially key contributor to wage and earnings inequality. Training offers one key tool when trying to combat rising wage inequality in general. Wages are suitable as a direct measure of productivity only in a traditional neo-classical labour market. The effects of internal or specific training are typically estimated to be negligible. Asplund points out that our current knowledge on the existence and magnitude of training market failures and their causes and consequences leaves a multitude of crucial questions unanswered: there does not seem to exist a common solution for all countries and all situations (public intervention policies should be tailored to fit the specific needs that exist in each country). There is a need to clarify how to correctly label the different modes of company-provided training. Companies should provide and pay for the general training of their employees. The training opportunities of the low-skilled are affected by a combination of labour market imperfections, credit constraints, and training market failures.⁴

4. The Perceptions some CEOs Hold about Corporate Training

Rothwell et al. explain that trainers and HRD practitioners play an important role in national workforce development. Training is essentially a short-term learning intervention designed for immediate performance improvement. There are inherent difficulties in making a transition from training and HRD to WLP. Traditional training and HRD methods need to be questioned and new methods need to be introduced. Rothwell et al. present key comparisons between the nature of learning in organizations and the relationships between the practitioner from the training, HRD, and WLP perspectives. The analyst role functions to provide proof of the necessity of training and shifts in employee behavior. Performance analysis combines traditional skill assessment and an intuitive ability to recognize training needs within the organization. Recognizing strong and weak competencies, and identifying where key skill training is needed, are important facets of the analyst role. A well-documented competency profile allows the organization to target training to people and areas that are in the most need. Partnering with departments to identify training needs integrates learning into an organization's culture. An uplifting training program rarely improves poor employee morale. If you view the work you perform as training, you will be viewed as

the person who facilitates training programs. The availability of highly professional and ready-to-use training resources from vendors has increased. The WLP field has evolved beyond training as the sole intervention for improved performance. The ways in which training is delivered will continue to change. The WLP professional is the person who arranges times and dates, and who facilitates training. CEOs want managers of WLP to interact with them directly on issues linked to training (WLP professionals are usually trained facilitators). Business and performance needs for training must be packaged with personal appeal and a professional sale.⁵

Tai aims to understand how IBM develops, implements, and determines the effectiveness of e-learning. IBM invests substantially in human capital, with a sizable portion of their training budget allocated for e-learning (e-learning is used to train channel customers along the supply chain). E-learning is an essential component of a corporate training program for many companies attempting to achieve their strategic goals and competitive advantage. IBM provides a unique context for leveraging e-learning to train its employees. Tai stresses that training must be purposeful to help corporations achieving their business goals. Using e-learning to train channel partners is a way to avoid the hassle of expensive travel. Traditional training can take too long to reach large groups. Many corporations realize the potential cost savings in moving from traditional training to e-learning. Classroom training still is the predominant means for corporate training (e-learning will take a long time to or may never replace classroom training entirely). The classroom training allows learners to be exposed to product training only one time. Tai contends that e-learning training is judged on the basis of relevance, rather than class hours. Tai puts it that classroom training offers a familiar and comfortable method that learners are used to, that e-learning in no way hinders the opportunity for traditional training, and that training should be tailored to the needs of individual organizations. No corporation can afford to take a hit-or-miss approach to training. To realize the broader impact of training, an organization has to go beyond measuring only dollars spent. E-learning can function well as pretraining to be undertaken before learners attend classroom training. Each business has its own way of carrying out training. The key value of digitization is to bring training to a common standard. Tai observes that standardization is the ability to train people in different countries with different lan-

guages in a quick, cost effective, and consistent manner. With e-learning, training and development professionals want to understand how long users were in there taking the test. Digitizing content⁶ means compression⁷ of training time.⁸

5. Conclusions

Dawe notes that the evaluation of training is often based on feedback from trainees, employees, line managers and customers. Asplund emphasizes that the reported wage returns on training highlight only average effects. Training improves an individual's employability and career prospects. Rothwell et al. think that the time frame for interventions is a longer term than a one-shot training event. Training and learning programs are a business function. Tai affirms that e-learning is becoming an essential component of a corporate training program to help corporations achieve their strategic goals and competitive advantage.

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HOW BAD GOVERNANCE PRACTICES INFLICTED SYSTEMIC RISKS ON THE GLOBAL ECONOMY

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ABSTRACT. Moosa holds that a major casualty of the crisis is the Basel II Accord: the main weaknesses of Basel II are reliance on rating agencies and the use of internal models to determine regulatory capital requirements. McIlroy says that banks are regulated because of the possibility of systemic risk. Yeoh examines the macroeconomic, accounting and finance, and legal and governance perspectives associated with the current financial crisis. Kang and Kim examine the market's *ex ante* valuation of the effect of post-acquisition governance activities on target value.

JEL: D81, G34, F01

1. Introduction

Moosa contends that the adoption of Basel II by itself could undermine the adoption of better public policy structures. Yeoh holds that the present global financial crisis is the largest socio-politico-economical event since the 1950s. Kang and Kim assert that the presence of foreign investors in the US economy has increased substantially over the last three decades.

2. The Problematical Features of Basel II and How the Global Financial Crisis Has Exposed These Weaknesses and Undermined the Accord

Moosa holds that a major casualty of the crisis is the Basel II Accord: the main weaknesses of Basel II are reliance on rating

agencies and the use of internal models to determine regulatory capital requirements. Regulatory capital requirements should protect financial institutions from insolvency (a firm that is adequately capitalised remains solvent if it is hit by a big loss event). Regulatory capital protects the creditors of a firm, not the firm itself. Basel II aims at setting capital adequacy levels that are high enough to absorb losses under foreseeable conditions, and may provide the wrong kind of regulation. The role of the regulators is to protect the soundness of the financial system. Leverage is motivated by the desire to maximize profit. The internal models of many banks performed poorly and greatly underestimated exposure to risk. “Sophisticated” risk models create a sense of complacency.

Moosa claims that the global financial crisis has demonstrated the procyclical nature of the banking industry. The resulting risk-sensitive capital requirements enhance the procyclicality of the banking system. Banking is a procyclical business: banks tend to contract their lending activity in recessions and expand it in booms, boosting the amplitude of the business cycle, and making recessions more severe and booms more inflationary. Risk-sensitive capital requirements increase when the estimates of default risk are higher, and vice versa. The procyclicality of Basel II results from the calculation of capital ratios on the basis of risk-adjusted assets. As Moosa puts it, through malpractice, the rating agencies played a major role in the materialization of the subprime crisis in 2007. Basel II has enhanced a certain faith in rating agencies, allowing them a free hand and a significant contribution to the crisis, and discriminates against small banks, less sophisticated banks and internationally inactive banks (small banks may feel that Basel II puts them at a competitive disadvantage vis-à-vis large banks). Pre-occupation with Basel II and its complexity hurts financial institutions during the crisis: it is not a risk management exercise and banks were concerned more with compliance than with actual risk management. Moosa asserts that Basel II was a catalyst for the problems experienced in the structured credit markets, and provides the wrong kind of regulation, ignoring liquidity and leverage. Basel II has underestimated some important risks and overestimated the ability of financial institutions to deal with them.¹

3. Local Conditions and Banks' Responses to Global Regulation

McIlroy says that banks are regulated because of the possibility of systemic risk. Governments take regulatory actions to monitor banks' activities and to restrict their profits in the interests of financial stability. The shape of the services expected by customers and of the activities pursued by banks vary significantly from country to country and place to place. Basel I required banks to hold specified amounts of capital in reserve against loans made in certain broad categories. The 2007 credit crisis could have been avoided if it were not for local conditions.

McIlroy suggests that a global financial regulator is not the answer to the problems that the sub-prime crisis has revealed, and proposes three modest regulatory reforms, which recognize the need to temper behavior by banks on the financial markets in the interests of stability in the financial system. A bank that becomes known for making reckless loans may find it difficult to sell them on. McIlroy claims that the economic justification for securitization enables risk to be distributed efficiently. The risks that banks are taking on have to be monitored by public authorities in the public interest. Banks are potentially forced to sell assets in a falling market, which thereby deepens the economic slump. Leaving the structure of CDOs to the markets has resulted in opaque financial products.²

4. Bad Governance and the Current Financial Crisis

Yeoh examines the macroeconomic, accounting and finance, and legal and governance perspectives associated with the current financial crisis, showing how and why bad governance is the more important factor contributing to the current financial disaster. Matters are aggravated by the forces of deregulation, freer global trade, and the closely intertwined global banking and financial networks. The transmission of capital from surplus to deficit economies was facilitated by globalization and financial deregulations. The Fed and the BE have been very slow to enhance interest rates when growths show signs of becoming bubbly. Yeoh thinks that international regulators, the IMF or the World Bank should co-ordinate cooperation between national financial regulators and supervisors to adopt good governance practices to counter problems posed by global capital imbalances. Market participants when confronted by a

different set of economic incentives, market structures and disclosure regulations will collectively respond to avert the current global financial crisis. Financial markets are complex, evolutionary and dynamic systems incorporating both rational and irrational behavior. Yeoh argues that current governance practices are generally underpinned by best practices that pay insufficient attention to the behavioral aspects of the governance process. The policy environment from the early 2000 onwards encouraged the underestimation of risks in the sub-prime mortgage market. The crisis is the consequence of a supply-driven bubble wherein asset-backed securitization failed. Investment banks' reckless expansions were prompted by their substantial investments in acquiring loan originators and connected real estate companies. The most important corporate governance failure of the sub-prime crisis is the excessive compensation of CEOs.

Yeoh points out that auditors are geared mainly to provide the assurance that the final accounts prepared are based on reliable systems of internal controls. When accountants certify dubious earning statements, various legal implications might arise. The principal financial regulators (the FSA and the SEC) have not done enough to restrain the reckless behavior of many in the banking industry until much too late. The FSA allowed perverse remuneration practices to flourish in the UK banking sector, contributing to systemic risk with adverse impact on financial stability. Governance would provide a more comprehensive take of the causes of the current global financial crisis (the bad or deficient governance factor in both the public and private sector represents the more persuasive underlying factor).³

Friedland stresses that the current financial crisis began with the problems in the subprime residential real estate market: accumulating losses on US subprime mortgages have triggered widespread disruptions in global financial markets. The market for structured finance of subprime residential mortgage-backed securities (MBS) has virtually collapsed. Interest rates were continuously below 3 per cent from September 2001 to May 2005. Market participants understated default risks, concentration risks and market and liquidity risks. One transaction of subprime mortgages can give rise to a chain of CDSs. significant reductions appear are in the best interest of lenders. Loan modifications have involved lowering of the interest rate or extension of the loan terms. Modification of mortgages through bank-

ruptcy is the most cost-effective. Friedland claims that the financial services industry has failed to implement loan modification on a sufficiently wide scale to stem the tide of the crisis. Consumer advocates document a litany of abuses by mortgage servicers. There is an increasing likelihood of recession from spillover effects of the crisis. Friedland adds that the proximate cause of the financial crisis is the mortgages themselves and the gratuitous manner of vetting the recipients, securitization and derivatives.⁴

Kang and Kim examine the market's *ex ante* valuation of the effect of post-acquisition governance activities on target value. Kang and Kim examine foreign investors' governance activities in domestic targets using a large sample of foreign partial block acquisitions in the US from 1981 to 1999. Targets involved in block acquisitions survive on the listing stock exchanges. Block acquisitions represent a setting in which large shareholders have strong incentives to monitor target managers. Kang and Kim find that foreign block acquirers are less likely to be involved in post-acquisition governance activities than are domestic block acquirers. There are some similarities in the factors that affect the likelihood of post-acquisition governance activities by foreign and domestic block acquirers. Kang and Kim examine the market's *ex ante* valuation of the effect of post-acquisition governance activities on target value using targets' announcement returns, and find that US targets of foreign firms realize higher abnormal announcement returns when they are located closer to their acquirers, when their acquirers have more acquisition experience in the US prior to the acquisition, and when their acquirers share a common culture with the US. Information asymmetries play an important role in discouraging foreign investors from engaging in governance activities in the host country.

Kang and Kim examine foreign partial block acquisitions in which the foreign investors acquire less than 50% of a target's shares. Kang and Kim compare the frequency of foreign block acquirers' governance activities in US targets with that of domestic block acquirers' governance activities, and investigate the effect of information asymmetries that foreign block acquirers face in the US on the likelihood of such governance activities, examining the cross-sectional variation of target abnormal returns. Compared with domestic investors, foreign investors have fewer incentives to engage in governance activities in domestic targets. In the US, investors located near a firm have an information advantage over other inves-

tors with respect to the firm. Kang and Kim predict that geographically proximate foreign block acquirers have stronger incentives to engage in active post-acquisition governance activities in targets than are remote foreign block acquirers, and capture geographic proximity using the physical distance between the foreign acquirer and the US target. Shareholder rights such as cumulative voting rights and proportional representation on boards of directors facilitate the governance activities of minority shareholders. The shareholder rights protection and governance systems in foreign countries with strong shareholder rights are similar to those in the US. Foreign shareholders from countries with strong shareholder rights are more likely to perform an active governance role in their host countries. Kang and Kim classify the post-acquisition governance activities that acquirers undertake into six categories: (1) hostile takeover threats; (2) proxy contests or threats; (3) expressions of opposition to or attempts to amend anti-takeover provisions; (4) efforts to seek representatives on the target's board; (5) threats of top executive turnover or involvement in the selection of a new top executive; and (6) demands for asset downsizing. Foreign acquirers undertake fewer governance activities when they face greater information asymmetry in the US. Information asymmetry plays an important role in explaining foreign investors' governance activities⁵ in domestic targets.⁶

5. Conclusions

Moosa explains that the Basel capital adequacy standards led to the growth of the market for mortgage-backed securities, the conduit to the global financial crisis. Yeoh writes that systemic risks can originate from any source and can be transmitted easily and quickly to the world economy in the absence of fast remedial measures. Bad governance in the public and private sectors is largely responsible for causing the present financial crisis (bad governance is very much a global phenomenon). Kang and Kim examine how the post-acquisition governance activities of foreign block acquirers in US targets differ from those of domestic block acquirers, focusing on the information asymmetries that foreign block acquirers face in the host country as a key determinant of the extent of their governance activities in domestic targets.

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DIRECTOR OVERLAP, ETHICAL FINANCIAL REPORTING, AND IMPROVEMENTS IN DISCLOSURE QUALITY

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ABSTRACT. Zheng and Cullinan write that the compensation committee manages the compensation schemes of top executives, and that the audit committee is charged with providing oversight of the financial reporting process and internal controls, and with managing the relationship with the external auditor. Persons claims that an independent audit committee contributes positively to ethical financial reporting and effective oversight of ethics programs. Felo and Solieri find a positive relationship between changes in independent audit committee financial experts and subsequent changes in analysts' perceptions of corporate disclosures.

JEL: G32, L15, M42

1. Introduction

Zheng and Cullinan focus on the performance-based compensation measure to explore in greater depth the relationship between director overlap and financial reporting quality. Persons identifies audit committee characteristics associated with earlier voluntary ethics disclosure among public companies that were investigated by the SEC for fraudulent financial reporting, and their matched no-fraud companies. Most companies assign oversight responsibility for ethics to the audit committee. Felo and Solieri maintain that audit committee expertise and independence are positively related to financial reporting and disclosure quality.

2. The Relationship between Director Overlap and Performance-based Compensation

Zheng and Cullinan write that the compensation committee manages the compensation schemes of top executives, and that the audit committee is charged with providing oversight of the financial reporting process and internal controls, and with managing the relationship

with the external auditor. The size and independence of audit committees are associated with positive outcomes, such as financial reporting quality and ethics disclosure. Director overlap is associated with higher-quality earnings, as measured by abnormal accruals. The quality of the board's compensation committee is associated with the extent to which the firm's executives receive performance-based compensation. Greater levels of option-based compensation are associated with lower financial reporting quality. Zheng and Cullinan examine whether director overlap between the compensation and audit committees may be associated with the prevalence of performance-based compensation of executive officers. Using a sample of 2678 firm-years, Zheng and Cullinan find that director overlap is not significantly associated with *cash* compensation measures (director overlap is positively associated with the extent of stock-based compensation, while overlap is negatively related to the extent of option-based compensation). Knowledge about the effects of different compensation schemes on the quality of financial reporting "spills over" from the audit to the compensation committee. The audit committee provides oversight of financial reporting and control issues, and manages the relationship between the firm and the independent auditor. Director overlap and performance-based compensation schemes are associated with financial reporting quality.

Zheng and Cullinan find an empirical relationship between director overlap and financial reporting quality, and between compensation schemes and financial reporting quality. Different types of pay arrangements may provide different levels of misstatement-inducing incentives. Cash-based compensation is less misstatement-inducing than option-based compensation. Zheng and Cullinan incorporate two equity-based measures of CEO pay. The higher the COMP measure, the more sensitive the executive's compensation is to financial performance. Option compensation may be more misstatement-inducing than stock compensation. Growth firms provide their managers with higher equity incentives to align their interests with those of shareholders. Zheng and Cullinan include a control variable for growth opportunities, using the market-to-book ratio (MV/BV) to proxy for growth. When the uncertainty surrounding a firm's performance is higher, it is more difficult for shareholders to monitor managers (Zheng and Cullinan include a control variable for idiosyncratic risk). Debt financing serves as a monitoring mechanism that can reduce the need for equity-based compensation.

Zheng and Cullinan measure CEO stock ownership as the percentage of common equity owned by the CEO. Equity-based compensation exerts relatively little pressure on a company's current cash flow. Cash compensation is not associated with whether the firm has directors serving on both the audit and compensation committee. Overlapping membership on the compensation and audit committees is not significantly associated with the cash component of executive pay. Stock-based compensation is more prevalent among firms with overlap, but that option compensation is less prevalent in firms with director overlap. Options may be misstatement-inducing, whereas share ownership is less likely to be associated with misstatements. Zheng and Cullinan argue that overlapping compensation committees may substitute stock compensation for option compensation. There is no relationship between the presence of directors serving on both the audit and compensation committee and cash-based incentive compensation. Cash compensation tends to be less misstatement-inducing than option compensation. Director overlap leads to less option-based incentive compensation. Knowledge spillover from the audit to the compensation committee is part of the mechanism underlying the relationship between director overlap and financial reporting quality. Placing the same directors on both committees leads to a reduction in the amount of option-based compensation provided.¹

3. Ethical Financial Reporting

Persons examines the disclosure in proxy statements and 10-K reports filed with the SEC *before* the SOX ethics rule became effective, investigating which audit committee characteristics are associated with the likelihood that a firm would make voluntary ethics disclosure *earlier* than its matched firm. An audit committee is the key contact authority in case of a major ethics violation. Audit committees with different characteristics are associated with different levels of voluntary ethics disclosure. Auditors are more able to perform their function ethically when the audited firm has a more independent audit committee. Persons claims that an independent audit committee contributes positively to ethical financial reporting and effective oversight of ethics programs. Audit committee members' accounting/financial expertise is an important factor in constraining the propensity of managers to engage in unethical earnings

management/manipulation. An audit committee with more accounting/financial experts will be able to perform their duties more ethically. Independent audit committees that meet more often perceive a high level of non-audit fees as a compromise to the auditor independence.

Persons holds that an audit committee that meets more often is more effective in monitoring management. Tenure increases the outside directors' ability to monitor management effectively for the prevention of financial statement fraud. Longer tenure of an audit committee contributes positively to monitoring effectiveness. The more additional directorships an audit committee member has, the less effective he/she will be, and the less likely it is that he/she will ask the firm to make earlier ethics disclosure. An incidence of fraudulent financial reporting is the best evidence of highly unethical conduct, and of an outright violation of securities law. Persons expects fraud firms to make voluntary ethics disclosure later than no-fraud firms.²

4. Improvements in Disclosure Quality

Felo and Solieri investigate changes in audit committee composition and changes in disclosure quality in a "lead-lag" fashion. Felo and Solieri find that disclosure quality is positively related to the percentage of audit committee members who are affiliated with companies providing services to the firm and who are financial experts and negatively related to the percentage of audit committee members who are related to firm executives and who are financial experts. Additional independent audit committee financial experts predate improvements in disclosure quality. Audit committees play an important role in ensuring the quality of firm disclosures. Regulators throughout the world should be cautious when considering implementing SOX-like audit committee requirements. Independent audit committee members and audit committee financial experts are positively related to factors expected to improve the financial reporting process. The lack of audit committee expertise and independence are both related to more frequent instances of financial reporting failures. Audit committee independence and expertise are positively associated with financial reporting quality. Market participants expect audit committee financial experts to improve financial reporting quality, resulting in an increase in firm value. Independent audit

committee members and audit committee financial experts are positively associated with activities that should improve a firm's financial reporting process and with financial reporting quality. Different "types" of gray audit committee members may have different relationships with disclosure quality. As analysts are sophisticated users of financial information and a firm's disclosures are evaluated by multiple analysts, Felo and Solieri expect the scores to be unbiased. Firms in some industries may have to contend with more difficult reporting issues than do firms in other industries.

Felo and Solieri compute industry-adjusted AIMR scores as the firm's raw AIMR score divided by the average AIMR score in the firm's industry, using the same industry classification system used by AIMR. Felo and Solieri's definition of "audit committee financial expert" is consistent with their measure of "disclosure quality". Felo and Solieri classify audit committee members as inside if they are currently employed by the firm, and include firm size as a control variable (larger firms may be able to devote more resources to financial reporting). Felo and Solieri do not have an expectation concerning the direction of the relationship between audit committee size and disclosure quality. The number of audit committee meetings may be related to financial reporting quality. Felo and Solieri expect disclosure quality to be positively related to independent directors and negatively related to gray and inside directors, and test H1a–H3a while controlling for firm size, institutional ownership, audit committee size, the number of audit committee meetings and board of director composition. Disclosure quality is not significantly related to any of their main explanatory variables. Firm size is positively related to disclosure quality and the number of board insiders is negatively related to disclosure quality (audit committee size is positively related to disclosure quality). Changes in independent financial experts are positively related to changes in disclosure quality. Adding independent audit committee financial experts leads to subsequent improvements in disclosure quality. Adding independent financial experts can improve disclosure quality. Felo and Solieri find a positive relationship between changes in independent audit committee financial experts³ and subsequent changes in analysts' perceptions of corporate disclosures.⁴

5. Conclusions

Zheng and Cullinan measure cash constraints as common and preferred dividends plus cash flows used in investment activities minus cash flows from operations, divided by total assets, and include stock returns as a control variable in the model of executive compensation. Persons observes that fraud firms are less likely than their matched no-fraud firms to adopt and disclose a code of ethics (because of the differences in their audit committee characteristics). Felo and Solieri classify audit committee members simultaneously based on their independence and expertise, classify “gray experts” based on whether they are family members of current executives, former firm executives or affiliated with companies providing services to the firm, and test whether changes in audit committee composition predate changes in disclosure quality.

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NEW MEDIA AND THE NATURE OF THE NEWS MARKET

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ABSTRACT. Fenton maintains that claims for the democratization of the public sphere relate to the accessibility of the internet to producers and users. Hilligoss and Rieh propose a unifying framework of credibility assessment in which credibility is characterized across various types of information resources. Pavlik claims that new media are exerting a profound effect on the role of the press in the democratic process. Palmer claims that the *paradox of user control* is that of the illusion of choice within which the user is offered up for a form of soft domination. Brodsky claims that the nature of the news is changing. Matheson writes that television, newspapers, texting and other widely available communication forms play an important role in mediating society to itself.

JEL: D83, L82, R31

1. Introduction

Fenton points out that the ability of audiences to go online, check reports and substantiate mainstream news perspectives for themselves leads to increased media literacy. Hilligoss and Rieh remark that people's perceptions of context influence credibility judgments on the interaction level in ways that go beyond the appearance, source, and content of information. Pavlik holds that providing more information does not necessarily lead to uniform increases in the public's knowledge levels. Palmer puts it that marketers are continually inventing new ways of making consumption a more engaging experience. Brodsky explains that the media disseminate information about countries and connects them through information. Sheridan Burns contends that critical reflection is an active commitment in journalists to scrutinize their own actions, exposing the processes and underlying values in their work *while* they are doing it. Matheson argues that the news does not simply reflect the world as if it were a mirror, does not simply construct a picture of the real but makes sense within a social context.

2. The Impact of New Media on the News

Fenton maintains that claims for the democratization of the public sphere relate to the accessibility of the internet to producers and users. Online journalism offers audiences a view of the world that is more contextualized, textured, and multidimensional than traditional news media. On-line news media frequently supply their users with further sources of information via hyper links. Readers have a greater impact on the news through an increase in the intensity of their exchanges with journalists and the presentation of their own views in online papers. As Fenton puts it, many of the positive claims for new media rest largely on the *potential* of new media to re-invigorate democracy. Mainstream news providers plough more resources into online operations that are generally loss makers. News may be transformed into a discourse of personalization, dramatization, simplification and polarization. The major news sites online provide little by way of original material. Studying new media and news purports that news is what those contributing to its production make it. Journalism increasingly consists of multiple voices.¹

3. The Development of a Unifying Framework of Credibility Assessment

Hilligoss and Rieh propose a unifying framework of credibility assessment in which credibility is characterized across various types of information resources. Expertise is closely related to user perceptions of the ability of a source to provide information both accurate and valid. People's credibility judgments need to recognize expertise to conclude that the information is trustworthy (credibility is a *chief aspect of information quality*). Hilligoss and Rieh observe that context emerges as an important factor influencing construct, heuristics, and interaction by playing a central role in the process of making a credibility judgment, creating boundaries around the information seeking activity or the credibility judgment itself (Figure 1). Credibility assessments are often made internally. Credibility should be investigated by taking into consideration multiple kinds of information media and resources that people are likely to use for their information seeking processes.

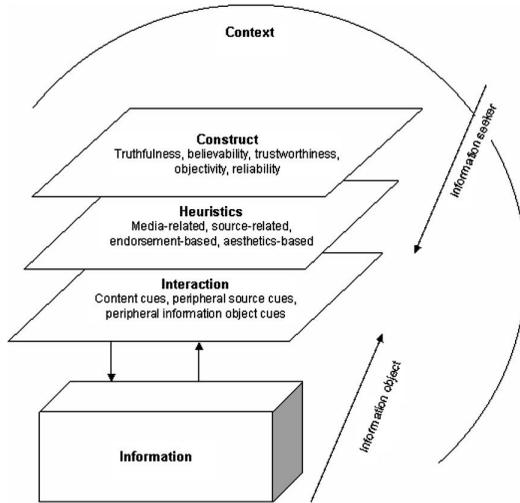


Figure 1

Hillgoss and Rieh assert that the construct level concerns itself with how a person conceptualizes and defines credibility, providing a particular point of view for judging credibility in fundamental ways. Content refers to the substantive information being conveyed. The use of personal knowledge to evaluate information is the primary method by which people interact with content from a credibility assessment perspective. Information object peripheral cues can evoke affective responses that may influence credibility judgments. Hillgoss and Rieh point out that contextual factors can intervene and influence credibility judgments by constraining selection of resources for a particular information seeking activity. Contextual factors enter into judgments of credibility by bounding or otherwise limiting the applicability of those judgments. Credibility may be seen as relative given its relationship to certain contexts of information seeking and use. Heuristics help people to judge information credibility somewhat intuitively and retain some consistencies across different information seeking and use situations. Credibility judgments taking place when interacting with specific cues are affected by credibility judgments made on the other two levels.²

4. The Capabilities and Aesthetics of New Media

Pavlik claims that new media are exerting a profound effect on the role of the press in the democratic process: civic journalism will become a vital part of the electronic republic of the twenty-first century, public electronic access to information relevant to the democratic process is expanding at an astounding rate, and citizens are increasingly able to obtain via the Internet information directly from political and governmental sources. Civic journalism refers to a form of journalism in which the press participates actively in the public life of the geographic, political, and cultural communities it serves (it is an increasing part of the new media landscape). New media are giving rise to a wide spectrum of opportunities for the public to connect to government directly (the members of the public are active participants in the communication process). Regulatory changes and emerging artificial intelligence tools exert profound influences on the nature of journalism in this century. Programming specialization will provide the best opportunity for quality programming, especially in the arena of news and public affairs. Pavlik claims that the tools of modern journalism are being transformed in a fundamental way in five broad areas: (i) news gathering and reporting; (ii) information storage, indexing, and retrieval, especially multimedia content; (iii) processing, production, and editorial; (iv) distribution or publishing; and (v) presentation, display, and access. The Internet leads a re-invention of how news is accessed, displayed, and presented to an increasingly global public. Pavlik claims that new media technology is enabling the emergence of a new form of news (*contextualized journalism*). According to Pavlik, the role of the journalist in an analog world has been dominated by three objectives: (i) to survey the world and report the facts as they are best understood; (ii) to interpret those facts in terms of their impact on the local community or society at large; and (iii) to provide opinion or editorial guidance on those facts.

As Pavlik puts it, change (as a result of an increasingly networked world) is happening in three fundamental ways: (i) the journalist needs to become much more than just a teller of facts (it is important to produce news abstracts that will provide the essential facts, and to produce the full exposition of the facts in context); (ii) the journalist's role as interpreter of events will be much expanded and somewhat changed (journalists will need to develop their role as

sense makers of events and processes); and (iii) online journalists will play a central role in reconnecting communities (the networked world requires journalists to be even more attentive to detail and accuracy).³

5. Influencing Public Perceptions through the New Digital Information Age and the Tailoring of the Media Imaginary

Palmer claims that the *paradox of user control* is that of the illusion of choice within which the user is offered up for a form of soft domination. Media products transform themselves into media services. Digital media increases opportunities for marketers to map consumer preferences with greater accuracy. Interactive television consolidates a process of “mass” rather than individual customisation. Palmer contends that digital media technologies are pulling television in two opposing directions: towards *individuation*, and towards *globalisation*. The illusion of user control corresponds to the idea of contemporary identity as a continual performative *task* of self-construction. The entire public sphere is swamped by forms of “public intimacy”. Palmer says that today’s new media aspires to represent only the individual user’s interests. The kind of world created by interactive or otherwise “participatory” media is an effect of the interface as much as any content.⁴

Brodsky claims that the nature of the news is changing. More news may lead to less as less space is designated for crucial background information. The media has a role in the public’s understanding of events. Pseudo-events and real events are packaged similarly in the mainstream press. Thinking about word choices will help consumers of news realize the influence of the press. Brodsky asserts that the news has the ability to shape institutional knowledge through inaccurate reporting, that the media has the ability to shape opinion based simply on the market structure, and that inaccuracies will exist because of the nature of the news market (the market runs the news machine). The structure of the news industry influences perceptions of the world outside our heads. The power of new information comes with the pitfalls of traditional media. Brodsky points out that consumers are not blind to the influential effects of framing in the media (framing creates a shortcut and makes events recognizable).⁵

6. The Use of News Language and the Meaning of the News

On Sheridan Burns' reading, the basic news values are: impact (it refers to the relevance a story has to the audience's lives); timeliness (refers to information that helps people organize their lives); proximity (it refers to how "close to home" a story is); conflict (it is the news value most people associate with media), currency (is the term used to describe how "hot" an issue is at any one time), novelty (it is given a high news value), and relativity (it is the most complex and subjective news value: relative news value is affected by the medium the journalist is using, and are stronger for print than for broadcast medium when it comes to disseminating complex information). "News sense" is finding ways to bring the audience into the story and making connections between facts and events, predicting the way an audience will react. Sheridan Burns reveals the process used by journalists to identify and evaluate potential news stories as a series of decisions that may be applied to every idea a journalist encounters (objectivity is a value-free concept). The media creates public figures by giving them repeated prominence.⁶

Matheson writes that television, newspapers, texting and other widely available communication forms play an important role in mediating society to itself (the shared world of a culture is partly constructed by each member and partly by institutions such as newspapers or radio stations): discourse analysis of the media analyses which representations of the social world predominate, what kinds of interactions media texts set up between people and the world and between the powerful and the rest, and how meaning is made differently in different media texts. The meaning of the news is about the act of deploying shared interpretative resources. News discourse is the result of the coming together of a variety of norms and principles and unstated assumptions. Matheson uncovers the social basis of the news, explores the role of the news in perpetuating or challenging that social base, and describes the power of the news to convince and manipulate. The news is reminding us of the resilience of already known structures of knowledge. News texts favor factual information, and actions are more verifiable as facts than emotions. The vocabulary of the news is strongly patterned. The use of news language is more of a rhetorical achievement than simply the reproduction of dominance. Lexical analysis on its own is not sufficient to understand the ideological force of media language. Dis-

course analysis of media texts cannot offer firm conclusions about the implications for individual readers (it provides analyses of the text and not of actual readers).⁷

5. Conclusions

Fenton states that news online does not automatically result in news diversity. Hilligoss and Rieh state that credibility assessment needs to be understood beyond the level of interaction. Pavlik asserts that new media developments are enabling the transformation of journalism and mass communication education. On Palmer's reading, there is a blurring between the production and consumption of media. In Brodsky's view, the new media structure has assisted the process of globalization and has provided access to many new users. Sheridan Burns explores the nature of news and the factors influencing the exercise of news judgment, particularly the role of intended audience, and provides a methodology for identifying news. Matheson asserts that the news is a social action done by journalists upon the words of others. Discourse analysis points a critical finger at newswriting, asking reporters to abandon the pretence that their language reflects the real.

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THE EFFECT OF GLOBALIZATION ON GOVERNANCE TRANSPARENCY

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ABSTRACT. Kang and Kim explain that domestic acquirers are more likely to engage in post-acquisition governance activities when targets suffer from severe agency problems. Al-Shammari and Al-Sultan suggest that Kuwaiti regulatory authorities require listed companies to establish audit committees to improve transparency. Elbannan contributes to the intense debate on costs and benefits of the SOX internal control-related provisions. Dong and Xue examine various domestic and international legal forces that are shaping and changing the environment within which listed Chinese companies practice corporate governance.

JEL: F01, G34, M42

1. Introduction

Kang and Kim measure the extent of target agency problems using two variables: free cash flow and past performance, expecting the likelihood of post-acquisition governance activities to be positively related to the extent of a target's free cash flow problem. Al-Shammari and Al-Sultan address corporate governance and voluntary disclosure in Kuwait, seeking to understand why companies disclose information in excess of requirements in a developing country where the government controls all aspects of accounting and financial reporting regulations. Elbannan examines the association between firm credit rating and quality of internal control over financial reporting. Dong and Xue argues that overseas Chinese issuers are subject to disclosure standards and financial reporting rules imposed by the regulators and legislators of the host market.

Chinese authorities do not allow domestic investors to have free access to overseas capital markets.

2. The Post-acquisition Governance Activities of Foreign Block Acquirers in US Targets

Kang and Kim explain that domestic acquirers are more likely to engage in post-acquisition governance activities when targets suffer from severe agency problems. Domestic investors who buy target shares through private negotiation are less likely to be involved in post-acquisition governance activities. The probability of post-acquisition governance activities is negatively and significantly related to the dummy variable for product market relationships. Distance is an important determinant of foreign acquirers' governance activities in US targets. Kang and Kim use the log of one plus the number of previous acquisitions that the foreign acquirer has undertaken in the US prior to the partial block acquisition, include a dummy variable for the same language that equals 1 if the primary language of the foreign acquirer is English, and use the cultural distance between the foreign acquirer's home country and the US. Kang and Kim examine the effect of minority shareholder rights protection on the likelihood of corporate governance and find that the coefficient on the difference in shareholder rights scores is negative and significant at the 0.10 level (greater information asymmetry in terms of investor protection provides foreign investors with fewer incentives to engage in an active governance role in the host country). The information asymmetries that foreign investors face in the host country have a significant effect on their incentives to engage in an active governance role in domestic targets. Hostile takeovers and board representations are important governance mechanisms that blockholders adopt to preserve their equity claims in their client firms.

Kang and Kim examine hostile takeover threats to investigate the role of large shareholders in the external corporate control market, and board representation to investigate the role of large shareholders in the internal governance system, and find that the results for hostile takeover threats are remarkably similar to those for board representation. Kang and Kim estimate marginal effects of information asymmetry proxies on the likelihood of post-acquisition governance activities. Geographically proximate foreign acquirers are about 5%

more likely to take post-acquisition actions than remote foreign acquirers. Foreign acquirers' incentives to engage in governance activities in US targets are economically as well as statistically weaker when they face greater information asymmetry in the US. Kang and Kim examine the effect of announcements of block share purchases on target value, and use as the market return the CRSP equally weighted return. US targets acquired by geographically proximate foreign investors realize higher announcement returns than those acquired by remote foreign investors. US targets realize higher announcement returns when their foreign acquirers have more experience in the US prior to the block acquisition. The extent of information asymmetries that foreign investors face in the host country is an important determinant of the source of target gains in foreign partial block acquisitions. Kang and Kim's results for fewer governance activities by foreign acquirers are robust to endogeneity of target selection.

Kang and Kim examine how the post-acquisition governance activities of foreign block acquirers in US targets differ from those of domestic block acquirers, focusing on the explanatory role of the information asymmetry that foreign block acquirers face in the US. US targets of such foreign block acquirers realize lower abnormal announcement returns. The extent of information asymmetries that foreign acquirers face in the host country is an important determinant of their governance activities in domestic targets. Domestic investors have stronger incentives to play an active governance role in influencing target management than do foreign investors.¹

3. The Impact of Corporate Governance Characteristics on Voluntary Disclosure

Al-Shammari and Al-Sultan define corporate governance characteristics as the proportion of non-executive directors on the board, the proportion of family members on the board, the presence of role duality and the existence of a voluntary audit committee. Industry membership has a significant influence on voluntary disclosure. Al-Shammari and Al-Sultan suggest that Kuwaiti regulatory authorities require listed companies to establish audit committees to improve transparency. Agency costs are associated with separate management and ownership. Banks, real estate and service industries are followed more closely by the public. Al-Shammari and Al-Sultan measure

voluntary disclosure using a self-disclosure index consisting of 76 information items. The average level of voluntary disclosure by the sample companies is 19 per cent. Voluntary disclosure increases with the presence of a voluntary audit committee and in larger companies. Al-Shammari and Al-Sultan indicate the need to improve Kuwaiti market transparency through additional constraints on corporate governance characteristics.²

4. Firm Credit Rating and Quality of Internal Control

Elbannan contributes to the intense debate on costs and benefits of the SOX internal control-related provisions, and examines the characteristics of firms receiving investment versus speculative rating grade: internal control quality decrease the likelihood of a firm receiving an investment-grade debt rating. Elbannan finds no evidence of a reduction in the explanatory power of the original association upon inclusion of CG formally in the model. Rating agencies do not place governance on the top of firm evaluation criteria for non-ICW firms. Elbannan hypothesizes that internal control quality, measured by the incidence on ICW, is negatively associated with firm credit rating, and presents the results of estimating each model empirically through an ordered logit model because credit ratings consist of discrete levels. Elbannan shows how ICW firms are more likely to suffer from lower profitability and operating cash flows, less stable earnings and high leverage. Well-governed firms are expected to have superior credit ratings. Internal control quality measures a separate aspect of firm performance (that is, the proper implementation of policies). Although CG strength appears to have a significantly positive relation to credit ratings, internal control quality retains its significant relation to credit ratings. Elbannan provides empirical evidence that firm credit rating is a function of internal control quality. Poor internal control negatively impact credit rating raise the question of why do not all firms practice effective internal control.³

5. The Regulatory Framework of Corporate Governance in China

Dong and Xue describe the gap between domestic and overseas governance environments, and analyze and compare three main sets of legal regimes relating to Chinese domestic and overseas issuers: (1) A or B share issuers in domestic market, (2) H-share or red chips issuers in Hong Kong and (3) N shares issuers in NYSE. Dong and Xue reveal the nature of China's corporate governance practice from both the local and global perspective, and focus on the effect of globalization on two main governance dimensions: (1) internal governance mechanisms and (2) governance transparency. Dong and Xue focus on two attributes of corporate governance: (1) internal governance mechanisms and (2) governance disclosure practice, to investigate how Chinese domestic companies differ from those overseas in corporate governance. Overseas companies generally disclose more information relating to governance practice than do the local companies. Governance problems in China are closely related to Chinese special economic, legal and political contexts. Dong and Xue select six governance variables to describe the internal governance environment: (1) number of special committees, (2) proportion of independent directors, (3) board size (4) separation of chairman versus CEO (5) salary ratio of board members and (6) local government influence.

Dong and Xue refer to three sets of governance disclosure regulations subject to locally listed, Hong Kong-listed (or incorporated) and US-listed Chinese companies, respectively. The incompleteness of a firm's governance structure does not automatically penalize the level of its disclosure adequacy. The CSRC and other policymakers update the disclosure and governance policy quite frequently. Dong and Xue investigate the governance disclosure at a general level, rather than the compliance of mandatory governance disclosure under different jurisdictions. Chinese companies vary in governance disclosure, depending on the type of information. Domestic and overseas companies have similar board sizes and a separation between chairman and chief executive director. Hong Kong-listed firms do not have more special committees than local firms. The overseas companies have more attractive remuneration packages than the local companies. Salary ratio and the development of a provincial governance environment are the key differences in

internal governance between Chinese local and overseas companies. Chinese companies issuing shares in overseas capital markets or incorporated under foreign jurisdictions differ fundamentally from local companies in their disclosure behavior. Chinese domestic and overseas companies differ in governance practices: they serve different investors' demands and are regulated under different legislation systems.

Dong and Xue examine various domestic and international legal forces that are shaping and changing the environment within which listed Chinese companies practice corporate governance. China's governance rules are leading Chinese domestic companies to establish governance structure with the characteristics of the two-tier governance model. Chinese companies have succeeded in transforming the governance system from its previous social-economic-based form to a market-orientated-based one. Chinese companies are not resistant to the ongoing reform of corporate governance. Imposing stricter governance rules than the current ones is likely feasible (but governance-related institutions should be developed consistently in China). Imposing a common-law-based governance system can dramatically change Chinese firms' former code-law-based disclosure practices. Chinese companies design their governance practices according to the applicable legislation systems. The improved governance disclosure in overseas companies⁴ is likely to be driven by the legal bonding of the external environment.⁵

6. Conclusions

Kang and Kim maintain that takeovers can improve target management or replace less effective managers with more effective managers. Al-Shammari and Al-Sultan argue that the level of voluntary disclosure is higher in larger companies and where a voluntary audit committee exists. Only the presence of a voluntary audit committee is an important factor in Kuwait. Size and cross-listing are significantly associated with disclosure quality. Elbannan points out that weak controls damage firm financial position and debt holders' interests. Credit rating agencies play a vital informational and valuation role in the capital market (credit ratings affect resource allocation in an economy). Dong and Xue aims to reveal the difference in governance practice among Chinese companies engaged in domestic or overseas jurisdictions.

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