

# NEWSLINK



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IDEAS AND UPDATES ON PUBLIC POLICY

Spring 2002

*Game theory, coming to a theater near you*

## Summer's here! Let the Hollywood games begin

**F**or his brilliant portrayal of mathematician John Nash in *A Beautiful Mind*, Russell Crowe won critical acclaim.

Based on the popular biography by Sylvia Nasar, *A Beautiful Mind* won the Oscar for Best Picture in March.

Nash's is a classic story of the triumph of the human spirit over adversity.

Having pioneered work early in his career in the emerging field of game theory, Nash overcame schizophrenia and, in 1994, along with two colleagues, won the Nobel Prize for Economics.

The science of strategy, game theory, attempts to understand, in mathematical terms, the actions of players in a set of games. Game theory examines the options for cooperation and competition between two or more players. The applications of game theory are numerous. Economists are interested in game theory because it helps them understand how competitors behave



when confronted with a set of choices on how to price their products. For example, consider the incentive for an individual member nation of the Oil Petroleum Exporting Countries (OPEC) to cheat on pricing and production agreements. If all OPEC members charge a high price, an individual member will be tempted to undercut prices a little and steal market share from fellow members. But if everyone follows

the same strategy, the whole group will be worse off, as everyone's profit margin shrinks.

Nash's contribution to game theory — one that bears his name — finds that in a particular game, if each player's choice of action is a best response to the actions taken by other players, then this set of strategic choices comprises an equilibrium.

In the OPEC game, if the member nations do not have a mechanism in place to guarantee cooperation, individual members will find it easy and tempting to charge low prices. If everyone is charging a high price, one player will benefit by charging a low price and securing more market share. If everybody is charging a low price, then it is hardly profitable for someone else to do differently. Thus the low pricing option for every player is the best response to everybody else's incentive to

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*From the Executive Director*

## Trading principle for plunder on Beacon Hill

**F**eeding frenzy. That's the best description of how the Massachusetts legislature has dealt with the supposed FY '03 budget crisis. It would be funny if it weren't so dismaying.

Here's what has happened: Because of a temporary revenue shortfall, brought about by 9/11, the economic slowdown and a weak stock market, the state would have to cut spending from about \$22.80 billion in FY '02 to about \$22.65 billion in FY '03, in order to avoid raising taxes. (This calculation assumes that the state would draw on reserves, tobacco

settlement money and other funds, as explained on our website: [www.beaconhill.org](http://www.beaconhill.org).)

That's a cut of about 0.7%. For a household that made \$50,000 in 2002, it's the equivalent of having to get by on \$350 less in 2003. No big deal, right?

But the Massachusetts legislature, egged on by the media and some business groups, has turned this minor spending cut into a very big deal indeed. Fanning worries about "draconian" budget cuts, the legislature is turning a \$150 million spending cut into an excuse for raising taxes by more than \$1 billion.

In 2000, Massachusetts voters overwhelmingly approved ballot measures to cut the income tax to 5%

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## Letters to the Editor

### *Braintree volunteer program makes "no economic sense"*

Editor:

I am writing to express my concern with the article entitled "Working off taxes" in your latest newsletter. I think the program is terrible economics and terrible social policy and am very surprised to find an article praising this program in your newsletter. For a local government to raise taxes to a confiscatory level only to then turn its senior citizens into wage slaves at minimum wage in order to save their homes is abominable. Furthermore, the work they do (according to the article) is not wanted or needed by the town to the extent that it is available; clearly an indication that the economics makes no sense. Also, to replace union jobs (even partially) at union wages with non-union workers at minimum wage is underhanded union-busting, a violation of any fair-minded collective bargaining agreement.

I urge you to do some logical analysis of this program as you have so brilliantly done in so many other areas of economic, political, and social policy. I look forward to a future article that really "makes sense for everyone."

Philip Belanger  
via e-mail

### *Raising taxes should not be first resort*

Editor:

I do not know whether the Beacon Hill Institute's estimate that state tax increases will hurt the economy of Massachusetts and cost jobs is accurate. The Institute has calculated that to keep the income tax at 5.3% would cost \$1.4 billion in lost wages, result in 32,000 lost jobs, and cause \$244 million in lost capital spending during the first year. Other tax hikes are estimated to have equally devastating effects.

What I do know is that the state does not have to risk such a scenario. If the first response of elected officials in difficult fiscal times were not to raise

taxes, ways could be found to close the gap between spending and revenue, even in this financial crisis. Some relatively painless means have already been suggested – like reducing the lottery payout by \$274 million, using \$146 million from the tobacco settlement and taking \$800 million or more from the estimated \$2 billion in the state's so-called rainy day reserves.

In addition, most citizens have their own favorite pet peeve when it comes to state spending. Their suggestions may save relatively small sums but these sums add up to substantial amounts. I would eliminate all public relations and press secretaries from state agencies.

It would save over \$10 million a year to eliminate free and cut-rate tuition at state colleges for government employees and their dependents. These colleges belong to all the people of the state, and fairness dictates that one group should not automatically receive financial benefits for which other people must compete.

The citizens of Massachusetts are not selfish. They would not mind higher taxes if they knew that all methods of increasing productivity and eliminating waste and special privileges had been addressed. And neither are our citizens stupid. They can see through the gloom-and-doom predictions that they are asked to swallow so that public officials will have an easier time extracting additional taxes.

A fiscal crisis like the present deserves statesmanship and it deserves sacrifice, but that sacrifice does not have to come from the children or the poor or the sick or the elderly. Nor should it come first from the taxpayers.

Peter G. Arlos  
Berkshire County Treasurer  
Pittsfield Councilman-at-large

### **BHI replies:**

We don't think things work as Mr. Belanger charges. As we see it, local government is going to extract either money or the equivalent in donated time from seniors and everyone else who pays taxes. So better that it offer a choice — pay or work — to taxpayers. Seniors often have more time than money, and, under this program, they get to choose where they'll work. When they pay taxes, on the other hand, the government takes the money and spends the money where it

wants. If Mr. Belanger can see our other arguments as "brilliant," we hope he can see this one as at least reasonable.

It is easy to agree with Mr. Arlos on the desirability of ending free tuition for state employees attending state colleges. There is little reason to believe that doing so would undermine the state's ability to attract capable workers. And, let's face it. This practice discriminates against private universities like Suffolk. On the other hand, we're a little less eager to eliminate state public relations offices. Considering how difficult it is to pry information out of state officials, it's nice to have somewhere to go where they can't duck your questions. As for the exact economic losses the forthcoming tax hikes will inflict, the trouble is that no one else wants even to ask that question, much less answer it.



*NewsLink* is published quarterly by the Beacon Hill Institute for Public Policy Research at Suffolk University. The Beacon Hill Institute focuses on federal, state and local economic policies as they affect citizens and businesses, particularly in Massachusetts. The institute uses state-of-the-art statistical, mathematical and econometric methods to provide timely and readable analyses that help voters, policy makers and opinion leaders understand today's leading public policy issues.

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## STAMP analysis informs debate on Florida tax reform

**L**ast February, the Florida House of Representatives turned back a sales tax overhaul that would have eliminated 35,000 jobs and cost \$1.3 billion in payroll according to BHI's State Tax Analysis Modeling Program.

By an overwhelming 99-0 margin, the lower chamber defeated a plan by Senate President John McKay that would have cut the state sales tax but would have also eliminated dozens of exemptions. Not a single House member spoke in favor of the proposal. In addition, Governor Jeb Bush opposed the tax plan.

At the invitation of the House leadership, David G. Tuerck testified against the tax package outlining the dramatic loss in jobs and payroll.

The McKay plan would have imposed a levy on nearly 1000 items and services currently exempt from Florida's

6 percent sales tax such as legal work, accounting and shipping.

Proponents argued that the tax plan, which proposed lowering the rate the rate to 4.5 percent, would have enabled the state to expand its tax base to cover more services not currently taxed.

However, the plan also poses a threat to the Florida economy. Despite its claim of revenue neutrality, the proposal would double-tax certain services such as accounting.

"It seems impossible for me to believe this bill is revenue-neutral," said David Tuerck, BHI Executive Director who testified before the legislature on February 20. "It's quite a nice tax increase for Florida households."

The BHI analysis also found that the proposal would have raised the tax burden on all Florida households and would be especially regressive since it would fall

harder on low-income households. Tuerck also suggested Florida's competitiveness rating in the *BHI State Competitiveness Report 2001* would improve if it cut taxes rather than raised them. Florida ranks 36<sup>th</sup> overall.

*By raising Florida taxes by \$536 million the so-called tax reform plan would have caused the loss of 35,000 jobs and \$1.3 billion in payroll.*



## Media Mentions

The great Virginian John Randolph of Roanoke once facetiously called spending other people's money "the most delicious of all privileges." By now, it is clear that the Massachusetts legislature finds great delectation in raising taxes and spending more money. As the Beacon Hill debate heated up this spring, BHI found delicious opportunities to argue against recently proposed massive tax hikes. And the opportunities to place stubborn facts in the way of a runaway tax-hike train were many.

BHI Executive Director David G. Tuerck hit the radio waves regularly to present the institute's extensive report, *Holding Taxachusetts at Bay*, which outlined the job and payroll losses associated with raising taxes. Dr. Tuerck appeared several times on Boston-based WBIX Business 1060 AM. On May 8 Dr. Tuerck appeared on "The Boston Business Journal AM Edition" with Dave Anthony & The Money Couple. On May 3 and April 16 Dr. Tuerck appeared on "The Bulldog Edition" with Ted Bunker to speak extensively about the proposed tax bills.

On May 3 Dr. Tuerck debated Massachusetts House Speaker Thomas Finneran on the "Blute and Ozone" morning radio talk show program on WRKO 680 AM. Dr. Tuerck questioned the House's approval of \$1 billion in new state taxes. He also challenged the House Speaker to provide an economic analysis of the proposed tax increases on job and payroll creation. Finneran defended the economic assumptions upon which the tax package was based. Dr. Tuerck reappeared on the the program on May 15. On April 30, Dr Tuerck was a guest on the David Brudnoy Show on WBZ-1030 AM.

Meanwhile, Dr. Tuerck also appeared on television to present the anti-tax side of the debate. On May 1, Dr. Tuerck appeared on "News Night," a New England Cable News program to discuss the ongoing tax increases. *The Neighborhood Network News* interviewed Dr. Tuerck for a news story that also appeared on May 1.

BHI's tax analysis also appeared in the print media. On May 4 the *Boston Globe* ran an op-ed column by Dr. Tuerck, "Holes in their

story about deficits," which called into question the state's fiscal crisis. And more significantly, the *Boston Sunday Herald* ran a major editorial on April 7 that used BHI's tax analysis to warn against higher taxes. On the heels of the release of BHI's report to Governor Jane Swift, *The Boston Metro* on March 12 also published a story.

Proposals to increase revenue were expanded to include the elimination of the voter-approved charitable tax deduction, another area of BHI expertise. On May 4, 2002 Dr. Tuerck was quoted in an article on the proposed elimination of the deduction. Previous to public discussion about the elimination of the deduction, the *Boston Globe* featured Dr. Tuerck in a explanatory article entitled, "Taxpayers to profit from generosity" on February 24.

On March 28 *The Boston Globe* also quoted Dr. Tuerck in an article on proposals to raise the cigarette tax in Massachusetts.

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## Hollywood Games

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charge a low price. Pricing low is the Nash equilibrium in such a non-cooperative setting.

And while the highly rarefied Nash equilibrium may not find its star affixed on Hollywood Boulevard any time soon, it is clear that the big-time studios know a little bit about game theory.

An examination of how studios strategize in their choice of release dates illustrates the point. Game theory can explain why you did not see *Spider-Man* go head-to-head against the latest *Star Wars* prequel from 20th Century Fox, LucasFilm's *Attack of the Clones*, on the same opening holiday weekend.

### *Which way do we go?*

Each major studio releases approximately 15 films a year including one or two potential blockbusters. Until recently, each major studio preferred to release their anticipated blockbusters close to four major holidays: Memorial Day, the Fourth of July, Thanksgiving and Christmas. Why are these times critical? People like to go to movies on holiday weekends. Because during these times, moviegoers are less likely to think about which film they'll take in; they flock to the megaplex or local theater with little regard for the latest movie reviews.

For a studio, holiday weekends mean a huge chunk of the revenue pie is up for grabs. Moreover, the first weekend for any movie can draw a significant portion of the film's final revenues. Thus, no one studio wants to find its blockbuster going up against a competing studio's blockbuster. So the game begins with movie producers asking themselves, "Do I want to be in the thick of competition and release my movie during a holiday weekend?" Or, "Do I really want to spend all that money advertising my movie?" Or, "Am I better off releasing the show on a non-holiday weekend?" It's a game that starts several months and sometimes a year or more in advance of a release.

How much is at stake? Take *Spider-Man* for instance. The movie cost Sony about \$150 million to make. Sony expects

to spend about \$50 million in marketing. The movie shattered first-weekend records in early May and was the fastest movie to reach the \$200 million mark. But its release date was almost entirely based on the threat of having to compete against *Attack of the Clones*, the latest *Star Wars* prequel described early on as "the franchise of franchises." As we went to press, the huge George Lucas PR machine was already in high pitch, with the creator appearing in



televised one-on-one interviews and other promotions just before the May 16 release.

Hollywood studios go to great lengths to avoid such head-to-head holiday weekend release competition. Theoretically they could collude and stay out of each other's way. But the anti-trust laws negate that option. The studios can't coordinate their schedules without getting into trouble.

This places the studios in a tight bind, since without coordination, the absolute worst scenario could happen: all the potential blockbusters could, in principle, be released at the same time! So what's the alternative? They try to schedule their films by signaling.

### *The thrill of the race*

Let's take a hypothetical example. When a major well-financed studio, let's call it Dismal Science Cinema, enters the 2003 Fourth of July holiday-weekend sweepstakes, it possesses private information about its featured film, *Rational Expectations*, a sequel to an earlier blockbuster, *Adaptive Expectations* (no comparison to Dickens intended). Dismal Science Cinema is also thinking about how

to place its remaining 14 films, some of which include romantic comedies and docudramas. Starting a year in advance, Dismal Science Cinema signals to other studios just how serious it is about launching a million-dollar advertising campaign for the blockbuster. Other studios will size up *Rational Expectations'* status as a sequel, knowing that the earlier film had already captured an audience. They will also take note of Dismal Science Cinema's ability to live up to its promise to spend heavily on advertising. Not known for its parsimony, Dismal Science makes what's called a "credible commitment." These two pieces of information are reliable indicators of whether Dismal Science will release *Rational Expectations* on the much-sought-after 2003 July 4<sup>th</sup> weekend. Once Dismal Science commits to this date, the studio's remaining films will then be distributed optimally throughout the rest of the year. Meanwhile, other studios will plan accordingly.

Knowing that the revenues will be limited by the presence of the 800-pound gorilla, *Rational Expectations*, the rest of the studios aim for an early June release. If a rival studio, 20<sup>th</sup> Century Keynes, finally realizes it can't compete with its own blockbuster, *To Demand is Divine*, it pulls out of the holiday competition — opting for a greener pasture and the next-best alternative of receiving a larger portion of a smaller pie of revenues on a non-holiday weekend.

### *Meanwhile, Back in Hollywood ...*

Sometimes studios gamble by trying to position their release based on the genre. Even the hot and heavy thriller *Rational Expectations* may not have the field to itself. A rival studio, Liquidity Films, may gamble on the fact that its movie, *Friedman in Love*, will find a niche for filmgoers who don't like action movies.

Recent trends suggest that year-round releases have eclipsed the holiday release game playing. Both

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## Plunder

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and to provide a tax deduction for charitable contributions, both of which the House of Representative overturned in the blink of an eye. Once they had this tax hike under their belts, our insatiable solons just couldn't restrain themselves.

Thus we had a proposal to abolish Proposition 2 1/2. Another to raise the sales tax a penny (call this the Southern New Hampshire Economic Revitalization Act). Still another to raise the auto excise tax. Hundreds of amendments to fund pet spending ideas. The list goes on.

It is hard to say which is more depressing: this rush to raise almost every tax imaginable – and to do so well beyond the requirements of the budget— or the insulting rhetoric with which the legislature has sold the whole scam to the public. Then there were the demonstrators, arriving with potted plants and cell phones to place their demands before the legislature. Trampled beneath the feet of this throng of special pleaders was the express will of the voters.

## Hollywood

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But recent evidence indicates that the four major seasons are still pivotal. The studios still play to win the big game around four major release seasons.

One soon-to-be released film, *Men in Black II*, cleared the field for this July 4 weekend by the sheer drawing power of stars Will Smith and Tommy Lee Jones. Insiders didn't even try to challenge *Men in Black II's* "credible commitment." Which goes to show that game theory is a concept that is hardly alien to Hollywood.

*Darlene C. Chisholm, PhD, Associate Professor of Economics at Suffolk University, assisted in the preparation of this article.*



Despite all this, the hope for principled government in Massachusetts has not died. Perhaps, indeed, it will turn out that this particularly atrocious exercise in bad government is just what the state needs in order to awaken itself to life's realities.

There was a sense, after the 2000 election, that all was well in Massachusetts. The tax cuts passed in that election marked the culmination of a process that had eliminated some of the worst anti-growth features of the state tax code. Our own *State Competitiveness Report* of last year showed that Massachusetts could hold its head high among other states, ranking second, as it did, for its ability to compete for workers and capital.

Now we find that the tax-and-spend beast had only gone into hiding. That it was there all along awaiting a chance to come out of its lair and jump on the hapless taxpayer.

So it's time to think big. Time to get rid of prevailing wage laws and project labor agreements. Time to get rid of the Quinn bill,

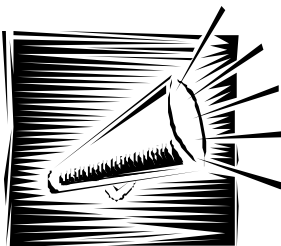


*It is hard to say which is more dismayingly: this rush to raise almost every tax imaginable or the insulting rhetoric with which the legislature has sold the whole scam to voters.*

additional assistance to local governments and at least a fifth of the Medicaid budget. It's time to put an effective restraint on the growth of tax revenues. Perhaps the goal should be to drive the state budget down to some really low number, say, \$20 billion, and leave it there for a few years to see just how cost effective state managers can be. If the legislature and the various claimants on state funds are going to complain about paltry budget cuts, maybe we should give them some real cuts to complain about?

Stay tuned. This issue will not go away. We will, in any event, do all we can to make sure it doesn't.

**David G. Tuerck**



## Make them listen!

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## Media Mentions

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### *Beyond Beacon Hill tax talk*

Highlights from other BHI research also made their way into the news. On May 5, the *Boston Herald* ran a column by Tuerck critical of the state's Medicaid rebate program for prescription drugs, "FDA's drug policy bad for our health."

The *Worcester Business Journal* interviewed BHI research economist John Barrett on BHI's study, *And Then There Were Nine: The States vs. Microsoft* for its May 8 issue. The same interview was also part of the newspaper's May 10 radio show in Worcester County called "Business Beat" on WICN 90.5 FM. The *Boston Sunday Globe* ran a column by John Barrett on the Microsoft anti-trust litigation on May 12.

On April 12 the *Boston Herald* reported on a BHI study concluding that forcing Microsoft to offer a stripped-down version of Windows in an anti-trust lawsuit will cost software developers and consumers millions of dollars. The *Boston Metro* on April 12 also

reported on the study. The *Metro* also carried a letter on a later day critical of the BHI study.

Pacific Radio International's *Marketplace* interviewed John Barrett about "sin taxes" for a story it carried on April 4 that appeared nationally and was cited on *American Health Line*, a wire service.

*Boston Globe* columnist Steve Bailey on February 22 cited an update of a BHI study that said the costs of the Massachusetts Turnpike were higher than the New York Thruway, New Jersey Turnpike and Pennsylvania Turnpike.

On February 21 Florida's *St. Petersburg Times*, *The Orlando Sentinel* and *South Florida Sun-Sentinel.com* mentioned Dr. Tuerck's role advising the state's legislature on a proposal to increase taxes. Dr. Tuerck said the tax increase bill would cost Florida 35,000 jobs and \$1.3 million in annual payrolls.

*Boston Herald* columnist Cosmo Macero Jr. quoted Dr. Tuerck in a February 20 column on the tax rollback as saying: "If 59 percent of the voters decide they want a tax cut, then everyone has a responsibility to respect that decision."

In its January issue, *Health Care News*, the monthly newspaper for health care reform published by the Heartland Institute, covered a report prepared by BHI that said single-payer health care in Maryland would cost the state as many as 117,000 jobs and almost \$5 billion in lost payrolls.

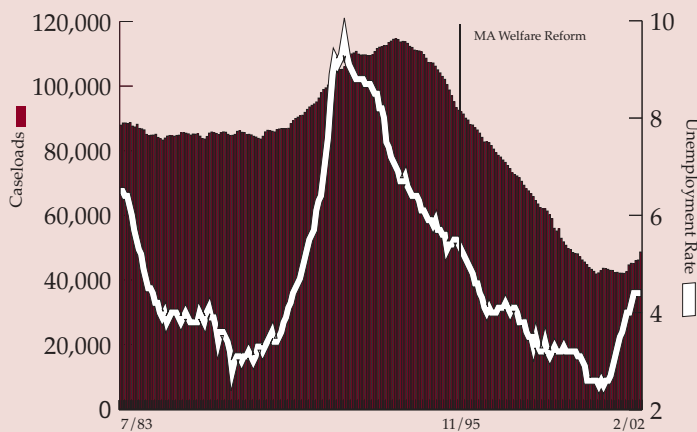
On January 12 Quincy's *Patriot Ledger* referred to BHI's report, entitled *Cashing in on Cable: Warning Flags for Local Government*, in an article on the entrance into the cable TV business by the Town of Braintree.

### *Continuing Coverage State Competitiveness Report 2001*

On April 14 the *Star Tribune* of Minneapolis, MN carried a story saying that Minnesota ranked ninth. On April 13 Maine's *Bangor Daily News* ran an article highlighting that Maine was ranked the 19<sup>th</sup> overall best state in which to do business in the country. A March 30 *Boston Herald* editorial cited the report in an editorial saying that per capita income has increased from 1980 to 1999. ❖

## Welfare reform's success

Massachusetts Welfare Caseloads and Unemployment Rates  
January 1983 - February 2002



Source: U.S. Bureau of Labor Statistics, Mass. Division of Employment and Training  
Massachusetts Department of Transitional Assistance

In November 1995, Massachusetts enacted welfare reform as part of an effort to decrease long-term dependency. An analysis of monthly unemployment and welfare caseload data for the period of July 1983 to February 2002 in Massachusetts (see chart) illustrates the changes brought about by welfare reform. From July 1983 through mid-1988 the number of welfare recipients was virtually unchanged even as the state unemployment rate was dropping. A statistical analysis applied to that period of time shows

that welfare caseloads were highly insensitive to changes in the unemployment rate and that there would have been 68,548 welfare cases even if the unemployment rate had gone to zero. This suggests that, before welfare reform, a sizeable number of what could be considered chronic recipients were unwilling to join the workforce.

Starting in late 1988, a statewide recession forced the unemployment rate to rise dramatically. This rise in unemployment added previously employed Massachusetts residents to the welfare rolls, culminating in a high of 114,671 welfare cases in May 1993. Soon thereafter, the state's economy began to rebound and welfare cases started to drop back toward its pre-recession level.

In November 1995 the state passed welfare reform, mandating work requirements and time limits. Thereafter the story changed dramatically. Caseloads began to fall in line with the decreasing unemployment rate. A statistical analysis applied to data for the post-welfare reform period shows that welfare caseloads have become highly sensitive to the unemployment rate and that the core group has diminished. In other words, welfare reform has succeeded in removing the disincentive to work and, in the process, reduced dependency on government. Our findings further suggest that a federal proposal to tighten work requirements would further reduce welfare caseloads. ❖

## More than a bubble: The Internet's still a big deal



*Beyond the Dot.coms: The Economic Promise of the Internet.*

Robert E. Litan and Alice M. Rivlin, Brookings Institution Press, 2001, 130 pages Reviewed by Frank Conte

**W**ho would have imagined that the “creative destruction” waged by the dot.com companies upon the old regime of the bricks and mortar establishment would, in an Internet minute, consume hundreds of e-commerce companies?

Today dot.com companies are the butt of bad jokes. In hindsight, the notion of bypassing the shopping experience with the click of a mouse appears all too foolhardy. Who would buy groceries, furniture, pet food or clothes on the web? A trip to the mall, despite the traffic, is far more rewarding than the endless search for the best bargain on Amazon. Moreover, the serendipity of shopping in a comfortable downtown area is far more enchanting than losing oneself in a deluge of information.

Yes, the dot.com stock market bubble burst and the cyber-optimists at *Wired* magazine look foolish. But that’s missing the point. The Internet remains a pervasive force in economic life. That’s the conclusion reached by two astute economists, Robert Litan and Alice Rivlin, who argue forcefully in their recent work, *Beyond the Dot.coms*, that the economic benefits of the Internet revolution are as subtle and significant as they are over-hyped and oversold.

As economists, Litan and Rivlin do not believe that the Internet has overturned veritable economic principles. They have a sense of proportion. In terms of size, e-commerce remains a small part of the overall economy – accounting for less than \$200 billion in a \$10 trillion economy. The Internet will not repeal the business cycle even though inventory reductions can be expedited. Nor will Moore’s Law – where computing power doubles every 18 months – overturn recessions. Nor are price discounts the perfect measure of performance. The price reductions promised by the web, while desirable, are not the Holy Grail: “Although the Internet may reduce profit margins among suppliers somewhat, any resulting reduction in prices that they charge will not directly reduce the quantity of inputs required to generate the same level of output – that is, they will not increase productivity. Instead, any cost savings from lower supplier profit margins will represent a transfer of income from suppliers to producers.”

What counts in the final analysis is productivity, which enables a nation to increase its standard of living. Once ridiculed, Old Economy companies like Fedex and GM and older sectors, such as transportation, and even the government will deploy the Internet to increase productivity for the benefit of everyone by using fewer inputs to produce more goods and services. The authors boldly proclaim that the “Internet is likely to add roughly 0.25 to 0.50 percent a year to US productivity growth (above what it otherwise would be) over the next five years.” Even in sectors that are difficult to quantify, i.e. transportation, productivity increases will spill over as inputs into other sectors such as manufacturing.

The authors pose a formidable question: “Will productivity move back up to the growth path of the last half of the 1990s, or will it fall back to the lower rates of the previous twenty years?”

After stalling in 1972, American productivity roared back in 1996 at a 2.5 percent rate for five years. Most economists attribute this growth to massive investment in Information Technology (IT). This continues to puzzle economists, because computers appeared on the economic scene far before the latest productivity surge. This phenomenon led Nobel laureate Robert Solow to famously proclaim “We see computers everywhere but in the productivity statistics.”

Nonetheless the authors are optimistic. “There is every reason to believe that the Internet will continue to add to productivity growth, regardless of what happens to the NASDAQ.” Whether this is sustainable remains, despite the authors’ predisposition, a tough question.

Some obstacles clearly stand in the way of the authors’ hypothesis. It is true that some transactions can be handled more efficiently with web-based technologies than paper. But American consumers lack faith in credit card transactions on the web, even though they are as secure as conventional ones. Secondly, the American consumer has, despite the latest gadgets of convenience, a long-standing love

*The authors boldly proclaim that the “Internet is likely to add roughly 0.25 to 0.50 percent a year to US productivity growth (above what it otherwise would be) over the next five years.”*

affair with paper; she is not about to throw out her checkbook nor her cancelled checks. And promises about the paperless office results in more paper prompting the joke: “We will have a paperless office when we have a paperless bathroom.”

Litan and Rivlin believe that the health care sector savings could reach \$27 billion if health insurance claims were shifted to the web. While they argue this could potentially lower costs for business, they largely ignore the fact that such cost savings would be temporary. They also suggest that telemedicine shows great promise. But one can only imagine the licensing and liability issues associated with giving medical advice via e-mail.

Government is an area that, the authors believe, will realize cost savings. The Internet helps government disseminate reams of information; but the Internet has not slowed down the growth of cost of government at all levels. Dealing with the government whether in person or on the web appears to be a deadweight loss. Reforming tax policy would be a good idea. Eliminating sales taxes would end the Internet state sales tax debate but place greater emphasis on income taxes.

Litan and Rivlin believe that the successful Dell computer made-to-order model can be applied to manufacturing, particularly to the automobile industry. But this is futile thinking given the general labor inflexibility of the automobile trade unions. For example, efforts to outsource spare parts, a key to Dell’s just-in-time success, are often met with resistance. Additionally disenfranchising automobile dealerships – that is, taking out the middlemen – may prove more difficult than diminishing the role of a stockbroker.

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## In Point of Fact

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*axing anything that moves like bullets.*

California State Sen. Don Perata (D-Oakland) introduced a bill

recently that would levy a 5-cent tax on every bullet sold in California. Perata said he wants the money to pay for hospital trauma centers, some of which are facing budget problems. "There's no reason why the general public should be paying for gunshot victims. It is an avoidable injury. It is a preventable injury and therefore I think it's fair to fix a very small tax on the sale of bullets," Perata said.

"State Senator Calls For Tax On Bullets," *Associated Press by way of SanDiegoChannel.com*, April 1, 2002.

### *The Aesthetics of the Laffer Curve.*

Europe's \$11.5 billion-a-year art market has lost its supremacy to the United States because of high taxes and stifling European Union bureaucracy, according to a recent report. Since 1998 America has increased its share of the international art market by seven percent and last year overtook Europe with a lead of 47 percent to 45 percent. "European taxes and regulatory structures have led to a widely held perception that Europe is a complicated, costly place to do business," said the report. Because

of this, trade is being lost to the US where taxes are lower, the general climate more favorable to business and where many wealthy art collectors live. The report said that the EU had ignored basic economic principles and not taken into account the effect of its own taxes. "Red tape and taxes cost Europe lead in art market," *The Daily Telegraph*, March 8, 2002.

### *Compared to paying taxes, cleaning the kitchen is a better deal.*

It's conventional wisdom among economists that Europe isn't as good at generating jobs as the U.S. is. Some evidence: Only 64 percent of the adult population under the age of 65 is employed in Europe, compared with 74 percent in the U.S. But according to a study by Richard B. Freeman, a Harvard University economist, and Ronald Schettkat, an economist at the Netherlands' Utrecht University, the lower employment-to-population ratio in Europe partially reflect that Europeans perform work at home for themselves, such as food preparation, that Americans pay others to do. In the early 1990s, Americans spent 59 percent of their work time in paying jobs outside of their home, while Germans spent 52 percent of their work time on work at home for themselves. That difference is even greater for women. American women spent 44 percent more time in market activities than German

women in the early 1990s, while German women spent a third more time in unpaid home production than American women. In the U.S. wages and taxes also come into play. In Europe, even many low-skilled workers have good educations and demand high pay. If a women can earn only a bit more by working outside the home than she would have to pay a cleaning lady, "it doesn't make sense to hire the cleaning lady," points out Freeman. Also, taxes on a second earner's wages are so high in Europe that it often doesn't pay for both members of a couple to work.

"Many Europeans opt for housework," Margaret Popper, *BusinessWeek*, April 1, 2002.

### *"Free" medicine is expensive but don't take our word for it.*

The Uncompensated Care Pool was started 17 years ago to spread the cost of treating the poor more evenly among hospitals. Because of new cost controls imposed by private and government insurers, the free care program now pays some hospitals better than private insurance companies do. Free care is one of the few systems left that pay hospitals a percentage of what they charge rather than the negotiated rates typical under managed care. Massachusetts free care "is mind-bogglingly generous," said Randall J. Bovbjerg, a health policy researcher at The Urban Institute in Washington, D.C. "Is that too much? The people in Texas think so. They would never pay for a system like that. People really like their health care in Massachusetts."

"Mass. free care turns divisive: Some hospitals benefit; others protest changes," Liz Kowalczyk and Anne Barnard, *Boston Globe*, April 17, 2002.

## BookMark

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Litan and Rivlin do not engage in the kind of irrational exuberance found in numerous books extolling the radical nature of the Internet. This is one of the virtues of the book. But their expectations about productivity need to be tempered. There is some evidence that the productivity gains of the late 1990s may be short-lived, if not illusory. One prominent New Economy critic, Robert J. Gordon of Northwestern University, has noted that the productivity revival—"is narrowly based in the production and use of computers" rather than across all sectors.<sup>1</sup>

<sup>1</sup> Robert J. Gordon, "Technology and Economic Performance in the American Economy," in *Technological Innovation and Economic Performance*, Benn Steil, David G. Victor, and Richard R. Nelson, eds., Princeton, Princeton University Press, pp. 49-73. A version can also be found at, <http://faculty-web.at.northwestern.edu/economics/gordon/Tech&Econ.pdf>



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