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ECONOMICS & Business

Whitman '49 Endowment Helps Students

David Fishman '07 (left), Vicente Arguello '08, Prof. Donald Chambers, and Lori Anderson '06 review details about their summer experiences funded by the Whitman Endowment.

The Gladstone T. Whitman '49 Endowment Fund provides Lafayette students with an opportunity for full-time summer internships or participation in seminars at nonprofit institutions that study free markets and economic liberty.

Three students took advantage of the opportunity offered by the Whitman Fund during summer 2005. **Lori B. Anderson '06** worked at the Institute for Humane Studies in Arlington, Va. She spent six weeks working at the Institute's offices and attended seminars at Duke University and University of Denver.

Anderson found the "Liberty and Society" seminars at Duke especially fulfilling. "What was cool," she says, "is that I got to meet some really extraordinary students and people out of school. They were from all over the world and really made the experience something special." She is now writing an honors thesis on the nature of economic freedom.

Vicente Arguello '08 and **David Fishman '07** interned at the Foundation for Economic Education in New York. The Foundation's five-week programs include daily discussions and biweekly lectures where students from around the world learn about philosophies of freedom. As interns, Arguello and Fishman assisted in setting up the seminars and then attended the presentations.

Arguello says that the internship helped him "become more aware of what is going on with government today. This will help me in the future because I will be more conscious of what the government is doing."

Fishman echoes these sentiments. "The programs stress the importance of the notion of the 'seen' and 'unseen,' which is a significant consequence of any intervention." He adds that he is grateful that Mr. Whitman's generosity offered him "a great learning experience."

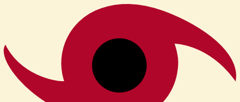
The Whitman Fund is currently administered by Professor **Don Chambers**. Anyone who is aware of nonprofit organizations with an emphasis on free markets that might serve as an appropriate host for summer internships is encouraged to contact him at chambers@lafayette.edu or (610) 330-5303. ■

In the News

Economic Impact of Hurricanes

■ by Howard Bodenhorn

The spate of recent natural disasters, such as the Indonesian tsunami, Hurricanes Katrina and Rita, and the earthquake in Pakistan, has economists thinking and writing about a host of economic questions that arise after disasters strike. It turns out, not surprisingly, that natural disasters affect individual decision-making and have national, even international, ramifications.



A Lesson from History

In a study of the San Francisco earthquake of 1906, economic historians Kerry Odell and Marc Weidenmier found that the quake and the subsequent fire caused damage equal to about 1 percent of U.S. gross domestic product. Even though the shock was localized, indeed much more localized than the destruction wreaked by Hurricanes Katrina and Rita, the effects of the 1906 earthquake shook the world.

Because foreign insurers were on the hook for much of the earthquake damage, large amounts of gold flowed from England to the United States. The unexpectedly sharp gold outflow prompted the Bank of England to raise interest rates and discriminate against U.S. borrowers in the London market. The Bank's policies pushed the United States into recession and laid the foundation for the Panic of 1907.

(continued on page 4)

Starting a Business

On October 12, the CIRCLE Entrepreneurship Series held its first lecture of the year. More than 150 students learned the nuts and bolts of starting a business from Jason Goldberg, a portfolio manager with Onyx Capital Management of New York City. Goldberg's engaging and interactive talk educated students on elements of starting a business. He shared amusing stories of Onyx's beginnings, ranging from negotiating office space to malfunctioning telephone systems. When he and his partners began a hedge fund, the famous Long Term Capital Management fund had recently been the subject of much controversy and "exploded," leaving the new Onyx partners to wonder what they were doing starting a hedge fund. He explained how this was one of the best things that could have happened to his company.

Goldberg chronicled the successful and not-so-successful operations of the firm since its inception in 1998. He gave all in attendance a true picture of the ups and downs of business ownership during the first five years. Following Goldberg in the second lecture of the semester will be Dr. Hal Singer who will speak on the creation of his economic consulting firm, Criterion Economics.

The CIRCLE Entrepreneurship lecture series is sponsored by the Robert F. Hunsicker Education fund. Members of the current CIRCLE team are **Stephen Caruso '06**, **Walter Losch '06**, **Nkrumah Pierre '06**, **Meghan Mannion '07**, and **Meghan Morel '07**. They are advised by **Sheila Handy** and **Chris Ruebeck**, assistant professors of economics and business. ■

From the Department Head

I am delighted to be back at Lafayette after a wonderful sabbatical spent in Paris. While I was on leave, I worked on my research concerning birth order, adolescents, and risky behavior. My sabbatical research was funded generously by both Lafayette and a grant from the National Institutes of Health.

Some of you might wonder what an economist is doing studying adolescents and their propensity to engage in various risky behaviors. We economists like to believe that our way of viewing the world can shed light on a variety of issues that might previously have been thought of as under the purview of other disciplines. For example, there are serious public health costs when adolescents engage in risky behaviors. Thus, for policymakers, reducing such behavior may be a priority. My research is designed to shed light on the factors that trigger adolescents to engage in risky behaviors including alcohol and drug abuse, and, as such, complements research by sociologists and developmental psychologists.

Related to this, Professor Larry Iannaccone of George Mason University gave a fascinating and well-received talk on the economics of religion. In his talk, he demonstrated how economic analysis of religious extremism, particularly the suicide bomber phenomenon, could be used to explain why some groups engage in such activity. Studying why people would want to be suicide bombers brings us one step closer to understanding this behavior.

On a more local note, many departmental faculty were involved with the first-year orientation program put together by Dean Fluney Hutchinson who is also an associate professor of economics and business. Four of us are currently teaching First-Year Seminars—the intensive writing and discussion courses that our first-year students take.

We welcome two new tenure-track assistant professors: Julie Smith and Michael Kelly. You can read more about their backgrounds on pages 5-6. We also welcome Lafayette's new president, Daniel Weiss, who comes to us from Johns Hopkins University. We look forward to working with President Weiss as he begins a new era of leadership at Lafayette.

Susan L. Averett

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Editor: Howard N. Bodenhorn
Professor
bodenhoh@lafayette.edu

Susan L. Averett
Professor and Department Head
averetts@lafayette.edu

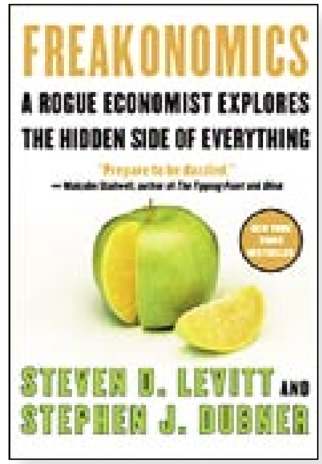
Lisa Mutton
Secretary
muttonl@lafayette.edu

Department of Economics and Business, Lafayette College, Simon Center, Easton, PA 18042 ■ (610) 330-5306, Fax (610) 330-5715 ■ **www.lafayette.edu**

For Further Reading

Where Have All the Criminals Gone?

by Ed Gamber



"Why do drug dealers live with their moms? The answer, according to Levitt and Dubner, is because they earn such low wages."

Where have all the criminals gone? According to Steven D. Levitt and Stephen J. Dubner, authors of *Freakonomics*, crime rates across the U.S. fell starting in the 1990s because abortion was legalized in the 1970s and many of the children who were aborted would have grown up to be criminals. In other words, crime rates dropped because the people who would have committed crimes simply don't exist. Some people might bristle at this finding (in fact, when this finding was originally published in an article by Levitt, it created a lot of controversy). But it is important to remember that economists ask *how* the world works, not how the world *should* work. Levitt and Dubner do not take a moral stand on whether abortion should or should not be legalized. They simply point out an unintended and previously overlooked consequence of legalization of abortion.

Do schoolteachers cheat? According to Levitt and Dubner, everyone and anyone can and will cheat if the payoff to cheating is large enough and the penalty for being caught (or the likelihood of being caught) is low enough. But aren't teachers supposed to be the moral beacons in our society? Levitt and Dubner say no, they are simply human just like everyone else and like all humans they weigh the costs and benefits of choices that they make. So when the Chicago public school system instituted a new policy that linked teacher salaries to student performance, Levitt and Dubner predicted that more teachers would cheat. They tested this prediction by looking for patterns in test score data that are unlikely to have occurred without cheating (an entire string of correct answers for an entire class). Levitt and Dubner found evidence of cheating in roughly 5 percent of the classrooms in the Chicago public school system. How did those teachers cheat? Levitt and Dubner hypothesize that the cheating teachers erased their students' answers and filled in the correct ones before handing the tests in to the testing authority to be graded.

Why do drug dealers live with their moms? The answer, according to Levitt and Dubner, is because they earn such low wages. Based on detailed accounting records collected from a gang of drug dealers in Chicago, Levitt and Dubner estimate that the pay for a street-level drug dealer is roughly $3.30 an hour. That explains why they live with their moms, but why does anyone become a drug dealer in the first place given that the payoff is so low and the risk is so high (a one-in-four chance of getting killed over a two-year period)? The reason is that the payoff for reaching the top of the drug organization is very large. Levitt and Dubner calculate that the drug gang's board of directors earned annual salaries of nearly $500,000—tax free! So given the potentially large payoff and the relatively low level of formal training necessary for entering the drug trade, the occupation of street-level drug dealing is overcrowded…and when a lot of people compete for a job, the wage rate falls.

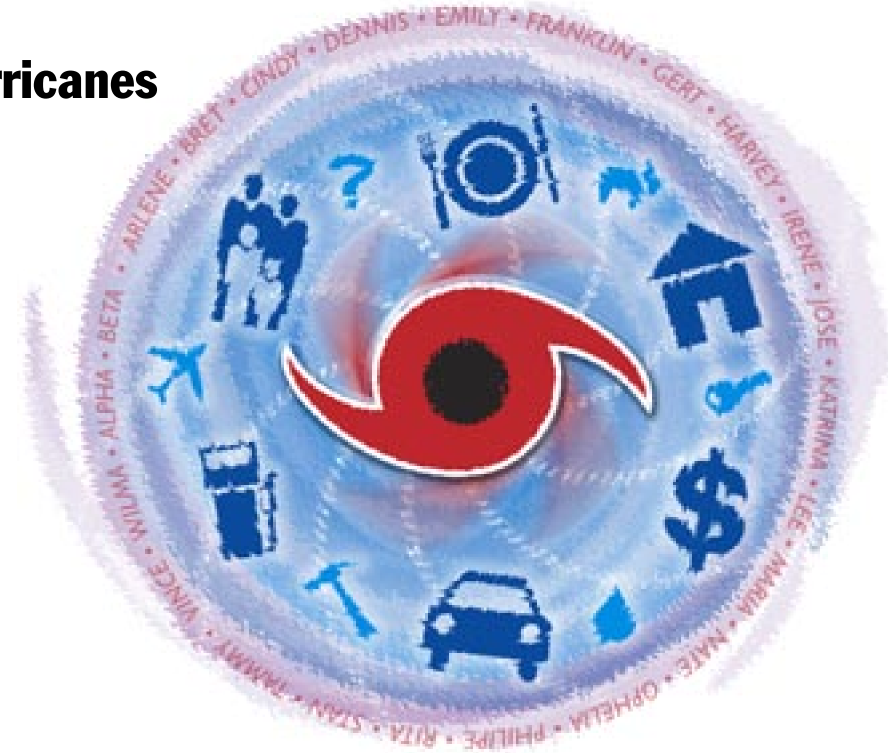
In addition to chapters on abortion and crime, cheating schoolteachers, drug dealers and their moms, *Freakonomics* has chapters on several other interesting but seemingly unrelated topics (sumo wrestlers, the Ku Klux Klan, real estate agents, parenting). If *Freakonomics* was only a collection of interesting insights by a quirky economist and his coauthor, it would still be worth reading. But, in fact, it is more than that. It is a book about how economic reasoning can be used to unlock a wide variety of everyday mysteries and quite often the unlocking of those mysteries calls into question the conventional wisdom.

One final story from their book illustrates my point. I think it is safe to say that conventional wisdom suggests that children who read do well in school. Levitt and Dubner ask whether reading actually causes students to do well in school or whether it just happens to be correlated with student academic performance. They find that simply having books matters more than reading. Children who grow up in households with a lot of books do better in school regardless of whether they actually read those books. This may sound odd since it is simply more believable that children gain valuable skills by reading and just on the face of it reading must correlate with higher school achievement. How does simply having books around the house make kids smarter? Levitt and Dubner don't mean to suggest that the knowledge from those books sitting around the house leaps off the pages and into the brains of children. Their point is that there is something else about households that have a lot of books that correlates with high student achievement. And a policy which focuses on getting books into the hands of children may be a waste of resources and may result in no real improvements in student achievement. ■

Freakonomics by Steven D. Levitt and Stephen J. Dubner, published by HarperCollins, 2005

Economic Impact of Hurricanes

(continued from page 1)



Hurricanes, Gasoline, and Giffen Goods

As we are all aware, one immediate consequence of the hurricanes was that gasoline prices rose sharply, to well over $3 per gallon in many places. Gasoline prices, if they remain high, will slow consumer spending in other sectors, which could lead to slower economic growth and to the Fed stopping its interest rate increases sooner than expected. For many people, however, the effects are much more immediate.

As Sasha Abramsky notes in *The Nation* (Oct. 17, 2005), economists are fond of talking about the mystical "Giffen" good. A Giffen good is a staple commodity that absorbs a large share of low-income household budgets. As the price of this staple rises, it absorbs a larger and larger share of household budgets, which leaves less for low-income households to spend on other goods. Instead of substituting less expensive goods in the face of the price rise, consumers, almost by necessity, spend more and more on the staple good.

This practice by the poor was offered by the English economist Sir Robert Giffen as an explanation for the dire consequences of the Irish potato famine. As the potato became ever scarcer, poor Irish families spent ever larger shares of their already meager budgets on the dietary staple. With small budgets squeezed by high potato prices, the poor had even less to spend on other types of food and household basics. Starvation was the result.

Of course, no one believes that Katrina will lead to mass starvation, but rising gasoline prices can severely squeeze already tight budgets of low-income families. Stuck with late-model gas guzzlers and the need to get to work and kids to school, low-income households may spend an increasing share of their budget on gasoline. Wealthier households can park the low-mileage SUV and drive their more fuel-efficient car. Poorer households without the fuel-efficient second car and without access to convenient public transportation will be much harder hit by the rise in gas prices because they are less able to substitute less expensive transportation.

To Rebuild or Not to Rebuild

President Bush's promise to rebuild New Orleans and Congress' throwing numbers like $250 billion in aid have led some economists to ask whether this would be money well spent. Writing in the *Economists' Voice* (October 2005), Edward Glaeser, a Harvard economist, notes that New Orleans is the only major Sunbelt city to have experienced a population decline in the past half-century. Between 1960 and 2004, the city's population has decreased from about 627,000 residents to about 445,000. Moreover, many of the city's former residents are poor. Annual per capita income in 2004 was less than $20,000.

Glaeser wonders if the government's implicit insurance obligation might be better spent by allocating $100 billion to an insurance fund and simply writing a check to every resident—man, woman, and child—for $75,000. This represents more than three times per capita income and would be a life-changing amount for many families. Families could move to a city with better employment opportunities. If they decided to stay in New Orleans, families could buy their own house or start their own business. They could send their children to college.

To Glaeser, the issue should be: do we insure people or places? As he notes, when a person "totals" a car, the insurance company doesn't rebuild it. The insured person receives the cash equivalent and is left to choose the option that will make the best of the situation. Drawing the analogy between the "totaled" car and the "totaled" city, it may well make sense to rebuild lives rather than the city. The case for rebuilding New Orleans rests on the belief that its denizens will be made better off by government-directed spending, rather than being given the cash-out option. Given the city's recent history, it is not clear that rebuilding is the better option. Indeed, the fact that so many former residents seem to prefer making a new life in Houston or San Antonio or Memphis even without the cash-out option is telling in itself.

Short-Term and Long-Term Effects

Although natural disasters can have large negative short-term consequences, the long-term changes wrought by disasters may be large and positive. Marc Weidenmier (*Atlanta Journal-Constitution*, October 23, 2005) points out that during the Panic of 1907 Westinghouse Electric collapsed. The stock market fell. Banks failed when they couldn't meet the demands of panicked depositors and the president of the failed Knickerbocker Trust of New York City shot himself. But the positive outgrowth of the panic was the National Monetary Commission formed in 1910, which recommended creation of the Federal Reserve to stabilize the banking system. With a couple hiccups, the Fed has worked pretty well since then.

In an article in the *San Francisco Chronicle* (Sept. 15, 2005), Kerry Odell contends that a second outgrowth of the 1906 San Francisco earthquake was the rise of Bank of America. While the smoke still rose from collapsed and smoldering buildings, A. P. Giannini reopened his then very small bank in the back of a produce wagon. His fame from this simple act grew, and he exploited California's loose banking regulations to transform his once modest enterprise into a modern financial powerhouse.

Although it will be some time before we see whether Katrina gives rise to new entrepreneurs, some pundits believe that the short-term effect of the hurricanes will be to decrease GDP growth by about one-half of one percentage point in the short term. But as rebuilding efforts get underway, the hurricane may actually generate a small increase in economic growth. ■

Students and Faculty Conduct EXCEL Research

Faculty and students continue the department's tradition of working together on research. Six students assisted faculty with their research through Lafayette's EXCEL program last summer.

Stephen Bruestle '07 worked with **Mark Crain**, Simon Professor of Political Economy, conducting research to improve the accuracy of the consumer confidence index, one of the most well-known and influential statistical indexes. This project could have significant impact on economic forecasting. Crain sees a shortcoming in the way the index is calculated and thinks a refinement will improve its predictive power. Bruestle researched and analyzed how the index is presently calculated and after gaining an understanding of the models and theories behind the index, he calculated standard deviations, probability values, and other economic statistical data to create a more accurate measure of consumer confidence.

Hurriya Burney '06 is working with **Howard Bodenhorn**, professor, on "A Longitudinal Study of African Americans in the Mid-19th Century." This study is part of a larger project on the economic well-being of manumitted and free-born African Americans in the mid-19th century. Using data recorded in the censuses of 1850 and 1860, this part of the project will link a large representative sample of black and white individuals between the two census years. In doing so, we will gain an understanding of the geographic and economic mobility of blacks relative to whites. There is much anecdotal evidence suggesting that black mobility was severely circumscribed, but this study will provide some much-needed evidence to the debate.

Dimitar Milenov Marmarov '07 worked this summer on "The Efficiency of New Jersey's Oyster Fleet in the Late 19th Century," with Bodenhorn and will continue through the fall with **Christopher Ruebeck**, assistant professor. Using detailed firm-level data from New Jersey in the 1890s, the project considers the efficiency of the state's oyster fleet. Oystermen in the late 19th century had access to several distinct technologies, including differences in ship size and type, seeding methods, and ownership of underwater beds. Using this information, this study will use stochastic production frontier estimation to determine whether oystering was subject to economies of scale and to what extent average technology diverged from best-practice technology.

Over the summer, **Maria Mileva '07** and **Dani Simova '06** worked with **David Stifel**, assistant professor, collecting data for a larger ongoing project for estimating the effects of obesity on cognitive ability, behavior, and the self-esteem of children. Mileva collected state, county, and school district data on such things as fast-food prices, restaurant availability, school vending-machine policies, and school physical education requirements. Simova prepared the National Longitudinal Survey of Youth for models which will estimate the economic determinants of child obesity and the cognitive and behavioral effects of child obesity. This is a continuing project for Stifel and **Susan Averett**, professor and head of the department. Simova is continuing this work fall semester and presented some preliminary results in a symposium organized for students by Skillman Library in October.

Matthew Weiss '07 and **Edward Gamber**, professor, are working on a project titled "Did Forecasters Anticipate the Great Moderation?" The Great Moderation is the term used to describe the abrupt decline in the variability of U.S. Gross Domestic Product (GDP) growth beginning in the mid-1980s. There has been a lot of work on the possible causes of the Great Moderation (better inventory management, improved monetary policy making, good luck). We look at the possible role that improved forecasting may have played in causing the Great Moderation. We find that the absolute value of forecast errors has fallen significantly since the mid-1980s for both professional forecasters and for the Federal Reserve. But relative to the size of fluctuations in GDP, forecast errors have remained unchanged over the period 1968 through 2004. Improved forecasting did not precede the Great Moderation suggesting that forecasters did not play a role in causing the reduction in GDP volatility. However, as predicted by rational expectations theory, forecast errors fell contemporaneously with the reduction in GDP volatility which means that there was virtually no lag time between changes in the behavior of the macro-economy and forecasters' incorporation of those changes into their forecasting models. ■

Michael Kelly Joins Department

Named a visiting assistant professor in January 2005, **Michael Kelly** became an assistant professor in July. His research interests include investments, derivatives, and risk management. He received his B.A. in economics from Harvard University in 1986 and a Ph.D. in economics from Cornell University in 1992.

Kelly brings a host of practical experience to his teaching of Corporate Finance, Investments, and Options and Futures, as well as Intermediate Microeconomics. Between 1992 and 1998, he was a member of J. P. Morgan's Equity Derivatives Group, where he headed the firm's global equity derivative research effort. In 1998 he became a founding partner of Onyx Capital Management LLC, a hedge fund that focuses on volatility strategies. He headed Onyx's domestic and international convertible bond activities.

Kelly has been quoted in the *Wall Street Journal*, *RISK* magazine, and *Barron's* on the relationship between index fund volatility and single stock volatility. ■

Faculty Publications

Susan Averett
(coauthors **Howard Bodenhorn** and **Justas Staisiunas '04**) "Unemployment Risk and Compensating Differentials in Late-Nineteenth Century New Jersey Manufacturing," *Economic Inquiry*, 43.4 (October 2005), pp. 734-49.

Howard Bodenhorn
Review of Stefano Battilossi's and Youssef Cassis' *European Banks and the American Challenge: Competition and Cooperation in International Banking under Bretton Woods* (Oxford: Oxford University Press, 2002), in *Financial History Review*, 12.1 (April 2005), pp. 115-22.

Review of Sean Patrick Adams' *Old Dominion Industrial Commonwealth: Coal, Politics, and Economy in Antebellum America* (Baltimore: Johns Hopkins University Press, 2004) in *Economic History Services*, EH.net Book Reviews (May 2005).

(coauthors **Susan Averett** and **Justas Staisiunas '04**) "Unemployment Risk and Compensating Differentials in Late-Nineteenth Century New Jersey Manufacturing," *Economic Inquiry*, 43.4 (October 2005), pp. 734-49.

Presented and published "Colorism and African-American Wealth: Evidence from the Nineteenth-Century South" (with coauthor **Christopher S. Ruebeck**) and "The Economic Consequences of Colorism and Complexion Homogamy in the Black Community," Southern Economic Association meetings, Washington, D.C. (November 2005); *NBER Working Paper Series* #11732 (November 2005).

"Usury Ceilings, Relationships and Bank Lending Behavior: Evidence from Nineteenth-Century New York," *NBER Working Paper Series* #11734 (November 2005).

Rosie Bukics
"Just One More Topic to Teach," *Pennsylvania CPA Journal* (Fall 2005), pp. 16-17.

Mark Crain
Presented (with Nicole Crain) "Terrorized Economies," The Political Economy of Terrorism at George Mason University Law School, Fairfax, Va. (May 2005).

James DeVault
"The Political Economy of Trade Preferences," *Contemporary Economic Policy*, 23.2 (April 2005), pp. 278-85.

Presented "Campaign Contributions and Fast-Track Negotiating Authority," Western Economic Association International meetings, San Francisco (July 2005).

Sheila Handy
Presented "A Comparison of Student Attitudes: Learning Accounting with a Preparer and User Approach," Academy of Business Education Annual Meeting, Orlando, Fla. (April 2005).

Christopher Ruebeck
"Model Exit in a Vertically Differentiated Market: Interfirm Competition vs. Intrafirm Cannibalization in the Computer Hard Disk Drive Industry," *Review of Industrial Organization*, 26.1 (February 2005), pp. 27-59.

(with coauthor **Howard Bodenhorn**) presented and published "Colorism and African-American Wealth: Evidence from the Nineteenth-Century South," Southern Economic Association meetings, Washington, D.C. (November 2005); *NBER Working Paper Series* #11732 (November 2005).

Julie Smith
"Inflation Targeting and Core Inflation," *Canadian Journal of Economics*, 38.3 (August 2005), pp. 1018-36.

David Stifel
Presented "Tracking Poverty in the Absence of Regular Comparable Household Budget Surveys—Case Evidence from Kenya," Northeast Universities Development Consortium (NEUDC) conference at Brown University, R.I. (September 2005). ■

Smith Joins Faculty

With research interests in monetary policy and macroeconomics, **Julie K. Smith** joined the department in July as an assistant professor. She comes to Lafayette from Trinity University where she was an assistant professor in the economics department. She grew up in Greenville, N.C., and received her bachelor's degree from Smith College in 1995. She received her Ph.D. in 2002 from The Johns Hopkins University.

Smith is teaching Intermediate Macroeconomics and International Finance. She is currently working on two research projects: one analyzing inflation forecasts and the other studying the relationship between oil prices and the macroeconomy. Her recent article, "Inflation Targeting and Core Inflation," appeared in the August 2005 issue of *Canadian Journal of Economics*.

Smith has presented papers on monetary policy at the Domestic Research Group of the Federal Reserve Bank of New York, the Monetary Assessment and Strategy Division of the Bank of England, the Federal Reserve Bank of St. Louis, and numerous conferences. She also worked as a visiting scholar at the International Monetary Fund in 2003. ■

Financial Reporting Requirements: Vive La Difference!

by Rosie Bukics

Everyone knows that France and the United States have had their differences. Some noteworthy, but less than newsworthy, differences are those involving financial accounting and reporting issues. It is important for people with aspirations of working in the international financial environment to understand the differences. These differences also influence how students are educated.

Students in the United States must understand and proficiently apply financial accounting and reporting principles set forth by the Financial Accounting Standards Board (FASB) and its predecessors, as well as any additional requirements put forth by the Securities and Exchange Commission. It is also useful for them to have a working knowledge of the international standards convergence project currently underway between the International Accounting Standards Board and the FASB.

For French students currently enrolled in the graduate program in international accounting at the business school (Ecole Superieur de Commerce) in Dijon, France, however, proficiency requires they must actually be competent in three sets of standards. Acquiring knowledge of both the French standards (used by all French companies except those listed on a stock exchange) and the international standards (required for any listing company in a European Union country beginning in 2005) is the primary focus of the program. However, understanding U.S. Generally Accepted Accounting Principles (GAAP) is also required. Thus the business school needs to find an instructor whose specialty is U.S. GAAP, but the person must also be knowledgeable about French accounting standards and international financial reporting requirements in order to discuss some of the differences among the three sets of requirements. Being able to speak some French, especially the technical accounting and financial terms, is a plus even though the students are all conversant in English. One additional detail: the crash course in U.S. GAAP is limited to 16-20 hours of instruction.

I have been fortunate to have the opportunity to fill this need for the past two years and it is a highly rewarding experience. The students are in their last year of graduate school in a program that accepts one out of six students and they are highly motivated. It also is a great benefit for me to teach in one of the best business schools in France. Vive la difference! ■

Speakers Discuss Religious Extremism and Prosperity

The department cosponsored some interesting speakers this semester, one of whom discussed religious terrorists and another who discussed the prosperity of the average American.

Laurence R. Iannaccone, Koch Professor of Economics at George Mason University, presented a lecture on “Religious Extremism: The Good, the Bad, and the Deadly.” The talk challenged the conventional approach to understanding radical religious terrorists, which focuses primarily on their theology. The theological approach fails to explain why extremist groups are sects and how sects gain strength and followers. Iannaccone suggests that sects are only one organizational form among many religious groups that satisfy a universal demand for the supernatural. He explains why a sect is particularly well suited to provide social services, political representation, law and order, and political violence when governments or markets do not provide such services. Iannaccone argues that understanding the sources of their organizational strength is key to designing policies that undermine the violent potential of terrorist sects.

Russell Roberts, professor of economics at George Mason University and J. Fish and Lillian F. Smith Distinguished Scholar at George Mason’s Mercatus Center, presented “The Goose that Lays the Golden Eggs.” His talk examined the development of the American economy in the past 100 years, seeking to dispel some common misconceptions regarding the prosperity of the average American over the last century.

“In many ways, a poor person today is better off than the richest person in 1900,” said Roberts. “The standard of living of the average American has increased by something between 5 and 30 times over the last 100 years. That transformation includes the trivial and the sublime, from flavored dental floss and video iPods to life-saving drugs and reductions in infant mortality.” ■

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Department of Economics & Business
Lafayette College
100 William E. Simon Center
Easton, PA 18042-1776

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Faculty Honors

James DeVault, associate professor, meets weekly with the student Fed Challenge Team.

At the annual trustee-faculty dinner this past spring, members of the Lafayette community were honored for distinguished teaching, scholarly research, and service to the College. **James M. DeVault**, associate professor, received a Marquis Distinguished Teaching Award for distinctive and extraordinary teaching, one of four annual awards provided by an endowed fund established by Walter A. Scott '59 and his wife, Kate. In addition, **Rose Marie L. Bukics**, Thomas Roy and Lura Forrest Jones Professor of Economics and Business, was one of nine members of the faculty and administration honored for 25 years of service to Lafayette. ■

Pop Quiz

Most graduates can undoubtedly recall at least one of their economics professors repeating, sometimes to the point of aggravation, the idea of opportunity cost. Economists believe that the idea of opportunity cost—the measure of the cost of any action is the value of the next-best foregone opportunity—is fundamental to an understanding of economics. Many graduates will also admit that the idea is sometimes rather tricky, especially when relevant opportunity cost is less than obvious.

It turns out that undergraduates are not the only ones who have difficulty with the notion of opportunity cost. Paul Ferraro and Laura Taylor, economists at Georgia State University, published the results of a survey they conducted with graduate students and professors of economics. As they note, practitioners of the "dismal science" performed dismally in their responses to what appears to be a simple opportunity cost question.

They presented economists and economists-in-training with the following question (the correct answer appears at the end of the column): *"You won a free ticket to see an Eric Clapton concert (which has no resale value). Bob Dylan is performing on the same night and is your next-best alternative activity. Tickets to see Dylan cost $40. On any given day, you would be willing to pay up to $50 to see Dylan. Assume there are no other costs of seeing either performer. Based on this information, what is the opportunity cost of seeing Eric Clapton?"*
A. $0 **B.** $10 **C.** $40 **D.** $50

Only 22 percent of those with at least some graduate training in economics selected the correct answer. The only group that did significantly better than average was economists who regularly teach microeconomic theory (43 percent). Two groups did significantly worse: those who teach business economics (15 percent) and those who teach macroeconomics (14 percent). As poorly as was the performance by professional economists, they still did better than undergraduates who had just discussed the concept in an introductory economics course. Only 7 percent of undergraduates selected the correct answer.

The results of the study were published in "Do Economists Recognize an Opportunity Cost When They See One? A Dismal Performance from the Dismal Science," *Contributions to Economic Analysis and Policy* (2005).

By the way, the correct answer is "B." The logic is as follows: You have a free ticket to see Clapton, but would willingly pay $50 to see Dylan. The actual cost of seeing Dylan is $40, so you will gain a consumer surplus of $10 by buying a ticket and attending the Dylan concert. Attending the Clapton concert, therefore, implies foregoing the opportunity to realize $10 in consumer surplus from seeing Bob Dylan. ■

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